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Federal Trade Commission

POST – PURCHASE CONSUMER REMEDIES

Policy Session

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FEDERAL TRADE COMMISSION
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OFFICE OF POLICY PLANNING
AND EVALUATION

April 2, 1980

MEMORANDUM

To: Commission

From: Robert B. Reich
Director

Re: Commission Policy Review Session on Post-Purchase Consumer Remedies, April 17, 1980

The attached briefing book was prepared for the Post-Purchase Consumer Remedies Policy Review Session, scheduled for April 17, 1980.

The briefing book sets out an analytic framework for selecting remedies regarding the aftersale performance of consumer goods and services. Section III discusses different strategies available to the Commission, and lists the relative advantages and disadvantages of each strategy.

I am forwarding separately a memorandum containing policy options.

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POST-PURCHASE
CONSUMER REMEDIES

BRIEFING BOOK
FOR
POLICY REVIEW
SESSION

APRIL 17, 1980

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POST-PURCHASE REMEDIES BRIEFING BOOK

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INTRODUCTION

Consumers use information to find and select the purchases that best meet their needs: information about price, quality, and availability. They also have concerns when shopping about how well different products and different sellers will serve their needs after the purchase. They can gather information on these aspects as well -- information about reliability, durability, or seller reputation. Consumers will often look beyond this information to the contract for some assurance that the purchases they select will continue to meet their needs and expectations. If the seller gives some assurance in the contract in this regard, consumers expect to benefit from that assurance.

These marketplace phenomenon are reflected in each of the following situations faced by consumers:

- A consumer in the market for a new car is looking for a model with a low expected cost of repair.
- A consumer has vowed never to make a big purchase from a firm that has refused -- wrongly, she believes -- to live up to its written warranty. When shopping for a new replacement, she wants to know which firms have the best record of living up to their warranty promises.
- A consumer makes a large purchase of resort property, relying on the salesperson's claims of value and explanation of the developer's plans for improvements. Later the buyer looks to the contract to see what can be done if the land's value was misrepresented or if the improvements are not made.

- A seller promises to provide a service and represents the quality as high. A consumer who signed a contract for a year's service soon finds that it is not as represented or as he expected, and wishes to drop the service and be relieved of the balance of the contract.
- A consumer learns that his year-old car has a serious engine problem that will cost hundreds of dollars to repair. He learns from the repair shop that many other cars of the same model have the problem; he wishes the manufacturer would pay for the repairs.
- A salesperson comes to a family's home unannounced with a "now or never" offer at what is claimed to be the lowest price available anywhere. They agree to make the purchase, but are not certain they have made a good bargain.

What is common to these typical situations is the consumer's concern with the suitability of the product or service after the purchase is made.

Surveys of consumer attitudes and experience reveal a great deal of dissatisfaction related to post-purchase issues. A major survey of consumer views concludes that after high prices, consumers are most concerned about "poor quality products, the failure of companies to live up to their advertising claims, inadequate after-sales service and repairs, the indifference of manufacturers to consumers, and the tendency of products to fail soon after they are purchased...," */ in that order. The survey also reports a

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*/ Consumerism at the Crossroads (Sentry Insurance, Marketing Science Institute, Harvard Business School, Louis Harris Assoc.), (1977), p.4.

"widespread belief that it is very difficult to get anything done when consumers have problems or complaints about things they have bought." */

Consumer perceptions are not the only, or necessarily the best, indication of what issues should concern a consumer agency. The most obvious limitation is that consumers may be unaware of problems like restrictions on competition that injure them greatly. But it is clear from the surveys that to the consumer constituency, post-purchase protection is important; they expect it from business and, when it is not forthcoming, some of them will turn to the legal process or to consumer protection agencies to remedy their post-purchase complaints. **/

Contracts may provide for events after the sale, sometimes putting the risk of problems arising entirely on the buyer, or entirely on the seller, or, most often, sharing that risk between the parties by some contractual formula. This might fall under one of several legal rubrics: warranty, trial periods, refund clause, or arbitration clause. These are the post-purchase remedy terms of contracts.

The term "remedy" here is used in its broadest sense, so that it encompasses all of these types of terms found in contracts even where there is no legal requirement that they appear. The FTC can also require certain remedies in contracts through its rules and orders. Thus the term "remedy" is used throughout the book to describe remedies in contracts without regard to why they appear, whether due to market forces or a legal requirement. Where we discuss FTC actions in this area we have used the term "interventions." These can take other forms than requiring contract remedy terms: the Commission can take steps to increase the information available in the market pertaining to risks and remedies, or to make it easier for consumers to enforce contracts. In reading this briefing book, this distinction between "remedies" and Commission "interventions" is crucial.

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*/ Id., at 5.

**/ Consumer dissatisfaction with various types of sellers and consumer complaining behavior are reported in A. Best and A.R. Andreasen, "Consumer Response to Unsatisfactory Purchases," 11 Law & Society 701 (1977).

Organization of the book

Section I of the book is styled as a catalog of Commission actions, or interventions, regarding PPRs. It describes the various rule and order provisions that in some way bear upon the remedies that consumers are offered in the marketplace and how they are enforced. As is apparent throughout the book, the catalog demonstrates that the Commission is only one of several agents that determine how contract terms are set and how they are enforced.

Section II, Overview, takes a broad conceptual look at the marketplace forces that determine how contracts are set -- specifically the post-purchase terms of consumer contracts. The discussion is explained largely in terms of the economics of insurance. While the discussion at times takes a theoretical turn, it underscores the essential point that post-purchase protection for consumers -- protection against the things that can go wrong with a transaction -- is in many respects like insurance: it is purchased and sold, it gives benefits upon certain contingencies, and it has limits to its application and benefits. We have found that an analysis focusing on the insurance aspects of post-purchase remedies leads to a better understanding of the dynamics of the market and of Commission interventions.

Section II.B. describes the market failures under which consumers may realize less than efficient levels of post-purchase protection. A variety of causes of these market failures are described; the importance of recognizing these different causes becomes apparent in the later discussion of Commission interventions, where we discuss the connection between market failures and effective interventions. The last part of Section II, "Failures of Equity", describes the market forces that may lead to inequitable contracts.

Section III of the book is a discussion of intervention strategies for the Commission regarding PPRs. Like the Catalog of past Commission interventions (Section I), it describes a spectrum of possible activities, ranging from information, to actions that help to enforce existing PPRs, to changes in contract terms. A summary at the end of the discussion of each type of intervention lists the advantages and disadvantages of that particular approach, suggesting some "rules of thumb" for selecting the best intervention for a particular problem.

The first strategy for Commission intervention explored in Section III is providing information. Here the discussion overlaps with the more extensive discussion in the Consumer Information Remedies briefing book; the emphasis here is on information that is particularly relevant to the kinds of post-purchase remedy terms consumers demand and find in contracts.

In discussing the second general type of Commission intervention, enforcing existing contract remedies, we have focused on only some of the possible types of intervention, particularly the alternatives to private enforcement through the courts. We do not discuss at any length direct Commission enforcement through rules and orders compelling seller performance of contract terms, or Commission efforts to secure for consumers redress through the courts. Direct enforcement is simple in its operation, but is greatly limited by the extensive commitment called for in Commission resources. The topic of redress actions is left to a more detailed discussion at some later date, when the legal and procedural issues surrounding the Commission use of this authority can be fully explored.

Lastly, we turn to assess direct Commission interventions to set contract terms--that is, to fix the post-purchase remedies. This has been divided into two discussions that group the remedies for easier explication: cooling-off and trial periods in Section III.D., and warranties and refunds in Section III.E. This division seemed to be the most logical and easiest way to make clear the explanation of the advantages and disadvantages of each type of intervention.

One topic which was considered but omitted from the discussion is the range of remedies that run to the benefit of creditors in loan contracts. The market and equity principles that govern these contract terms are basically the same as those discussed in this briefing book. However, a crucial conceptual difference is that the remedy terms of the agreement are drawn largely for the protection of the business-creditor, and it is the consumer-debtor that poses the risk of post-purchase (that is, post-loan) non-performance. We felt that the discussion would be unnecessarily confusing if it repeatedly reversed the assumptions regarding which party bears the risk and which benefited from the contract remedy terms. Nevertheless, the conceptual framework for analyzing post-purchase remedies applies equally to creditors' remedies issues.

Appendix A recapitulates the summary of advantages and disavantages of the various Commission intervention strategies set out in Section III.B-E. Appendix B is a representative (not exhaustive) list of past Commission cases and rules employing each of the strategies, and is intended as a reference. State interventions are similarly listed in Appendix C; this representative list of state statutes (it does not include administrative rules) shows that the state legislatures have taken a great variety of approaches to consumer post-purchase problems. The impact of these measures in the states can be examined to predict the impact of similar proposed interventions. Appendix D reproduces some examples of forms and contracts to illustrate points made in the text.

EXECUTIVE SUMMARY

This book provides a framework for analyzing Commission interventions designed to deal with consumers' post-purchase problems. Post-purchase problems -- product defects, poor product quality, unsatisfactory services, failure to live up to warranty obligations, and so on -- consistently rank as the most frequent source of consumer complaints. The Commission has often been able to intervene on behalf of consumers to reduce or correct these problems.

When faced with a post-purchase problem, the Commission has a number of intervention strategies to choose from:

Information strategies allow consumers to select products or services on the basis of more accurate information about the expected post-purchase performance, thus giving sellers more of an incentive to improve that performance. Information strategies can be designed to increase consumer information about the quality and performance of the product itself, about the post-purchase remedies */ offered by the seller voluntarily (e.g., warranties or refunds) or about the seller's record of living up to the terms of the warranty or refund provisions.

Enforcement strategies -- ranging from requirements that the seller state his obligations explicitly in a contract to

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*/ In this book we use "post-purchase remedies" (or "PPRs") to describe all methods of reducing the risk of post-purchase dissatisfaction, whether adopted voluntarily by sellers or imposed by Commission order. Thus, when speaking only of Commission actions, we will refer to them as "interventions" rather than using the potentially confusing term, "remedies".

the creation of non-judicial dispute resolution mechanisms -- are designed to reduce the cost to consumers of enforcing the performance promised by sellers, or of obtaining redress if those promises are broken.

Finally, in some cases the Commission can impose mandatory PPRs, which require sellers to assume additional obligations or to give buyers additional post-purchase options. Requiring sellers to offer cooling-off periods, trial periods, and refunds fall into this category, as do requirements that the seller repair or replace products which turn out to be defective. (A fourth possible strategy--requiring products to be produced according to standards set to minimize the likelihood of subsequent breakdowns -- is not used by the Commission.)

The common factor in all of these strategies is that they are all designed to reduce the risk of post-purchase consumer dissatisfaction. This risk cannot be reduced costlessly, of course. It costs money for a seller to improve a product, or to repair it if it breaks down, and these costs will generally be passed back to consumers. However, in many cases consumers would prefer to pay these costs as a form of insurance against post-purchase failures, rather than bearing the costs of product failure directly (in the event of a post-purchase breakdown). In fact, sellers often offer PPRs voluntarily to satisfy consumers' demand for this kind of insurance. Trial periods, money-back guarantees, and warranties are all common in the marketplace; on many products, offering some form of warranty or other PPR is essential to maintain a competitive position.

Most problems in this area can be traced to "market failures" which prevent the market from leading sellers to offer the optimal level of PPRs. If consumers have trouble comparing the PPRs offered by various sellers, for example, it will be very difficult for sellers to attract more customers by offering a better PPR (e.g., a more extensive warranty), and therefore the market will not provide sellers with the correct incentives to do so. The same is true if consumers lack information about sellers' records of performing their PPR obligations, or if they underestimate the underlying risk (e.g., the likelihood of a post-purchase breakdown) that the PPR would cover. High enforcement costs represent another market failure: to the extent that they make it difficult for consumers to enforce their rights, these costs make it easy for sellers to offer extensive PPRs but balk at performing them. In some cases -- though this is much more difficult to determine -- the existence of monopoly power may give the monopolist an incentive to offer inferior PPRs.

Other problems, however, may be inherent in the nature of some PPRs. If the risk of post-purchase dissatisfaction is also influenced by consumer characteristics and behavior -- e.g., frequency of use, type of use intended, and care in performing preventive maintenance -- then problems of moral hazard and adverse selection could prevent sellers from offering extensive PPRs. This will take place only if giving consumers insurance against a particular risk would reduce their incentives to take steps to prevent failure (e.g., preventive maintenance), or attract an undue proportion of consumers whose risks are naturally higher (e.g., heavy users), thus increasing the total likelihood of breakdown and raising the cost of the remedy. Unfortunately, unless some method can be found for efficiently distinguishing high-risk from low-risk consumers, these problems are impossible to correct.

In addition to these market failures, problems may also arise when the marketplace leads to results deemed to be inequitable. Historically, the Commission has invoked principles of equity when the PPRs offered by sellers seemed to impose oppressive obligations or risks on some consumers, or when products were being sold by high-pressure techniques which induced consumers to make their decisions in an unduly vulnerable state. In most cases, the equitable results were also supported either by principles of economic efficiency and/or by public policy as reflected in state statutes or principles of common law dealing with similar practices.

In designing an intervention strategy, the logical starting point is often determined by the nature of the market failure. Failures due to information costs suggest information strategies, for example; failures due to enforcement costs suggest enforcement strategies. As a rule of thumb, it will also help to start by considering intervention strategies (such as information disclosures) which leave the greatest flexibility to market forces while still accomplishing the desired end. These interventions will usually impose the lightest enforcement burden on the Commission; they also tend to minimize the chances of undesirable side-effects due to locking the market into a particular remedy or structure which later becomes inefficient. However, the intervention must always restrict the market enough to solve the original problem, and the ultimate test of any remedy is whether its costs are outweighed by its benefits. While these costs and benefits can only be measured in the context of specific cases, some general advantages and disadvantages can be noted here. */

Information interventions, not surprisingly, are most effective at remedying information market failures. Information about product quality and performance allows consumers to select those products which are most likely to provide satisfaction and least likely to break down. Information about sellers' PPR offerings allows consumers to patronize those sellers who offer the desired amount of post-purchase protection; information about PPR performance allows them to avoid those sellers who do not live up to their obligations. All of these interventions preserve most of the market's flexibility, by allowing consumers to select and sellers to offer varying levels of PPR protection. However, in some cases it may be difficult to collect the necessary information (e.g., accurate figures on the likelihood of breakdown), or to communicate it (as in the case of information about PPRs and PPR performance) in a form that can be easily understood and used by consumers. In addition, information strategies may be insufficient if some other market failure, such as monopolistic market structure or adverse section, is the cause of the problem.

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*/ Non-economic benefits and costs--principles of equity, along with such general factors as the benefit of maintaining consumer faith in the marketplace and the cost of restricting business managers' control over their own enterprise -- should also be included in the calculus.

Interventions designed to reduce consumer enforcement costs can take several forms. The least restrictive -- requiring sellers to state their obligations explicitly in the contract, rather than leaving the contract silent, to be supplemented by common law or by Commission rule -- would better inform consumers of their rights, and would also make their position somewhat stronger in the event of a dispute. It preserves a large amount of market flexibility, by allowing the seller to choose the level of commitment to make -- but for this very reason, this strategy may be ineffective if there is some other market force leading the seller to select a suboptimal level. In addition, this strategy still leaves it to consumers to bear the litigation expenses involved in enforcing their rights.

A more fundamental attack on the problem of enforcement costs might involve the establishment of some form of low-cost consumer dispute resolution mechanism (CDRM). These might (if successful) reduce the cost to consumers of enforcing their rights, while still leaving sellers the flexibility to choose what level of PPR rights to offer. Significant issues remain, however, as to the design that such CDRMs ought to take (including the fee, if any, to be charged for their use), and the circumstances under which the Commission would be justified in mandating a seller's adoption of a CDRM.

Mandating a particular PPR or particular terms in PPRs is a somewhat more restrictive intervention in that it specifies one aspect of PPR protection which the market will be required to offer.

Mandating cooling-off and trial periods are somewhat less restrictive than interventions which mandate other PPRs terms. These periods can permit buyers to recover from the effect of high-pressure sales tactics, to collect information about competing offers, and (in the case of trial periods) to gain some direct experience with the product before making an irrevocable commitment. Thus, such remedies may be considered as substitutes for information remedies when the relevant information can be more easily gained by experience than by reading some complex disclosure, or when the information would probaly be overcome by high-pressure sales tactics which minimize the product's risk. However, such requirements may involve significant administrative costs; in the case of trial periods, the depreciation of products which are returned as "used" at the end of the period could also be a significant cost. In additon, this strategy will only prevent those defects or other causes of post-purchase dissatisfaction which can be discovered during the relatively short initial period.

Mandating that the seller assume the obligation of repairing or replacing defective products, or providing some kind of refund, is a much more sweeping intervention. This strategy provides customers with increased protection against post-purchase dissatisfaction; by shifting that risk to the seller, it also gives the seller an incentive to take all cost-effective steps to reduce that risk. Even in cases where a less-intrusive information intervention could give consumers enough information that the market would provide additonal PPRs on its own, mandating the additional PPRs could still be more efficient if the cost of collecting and effectively communicating that information to consumers turned out to be prohibitive. However, sellers may well balk at performing their obligations under the new PPR, so any intervention which mandates an additional repair or refund obligation may also have to provide for enforcement of that obligation, which will increase the Commission's enforcement burden. If there are problems of adverse selection or moral hazard, as discussed above, mandating a higher level of PPR protection may aggravate those problems and increase the costs of the remedy. Finally, mandating a particular PPR term reduces the market's flexibility, and it may be necessary to monitor the requirement to make sure that changes in consumer preferences or other market conditions do not render the mandated PPR term too costly or inefficient.

I. CATALOG OF COMMISSION ACTIONS REGARDING PPRs

We begin our discussion with a catalog of FTC interventions that set or in some way effect the PPRs found in business-consumer contracts. This brief descriptive catalog sets the framework for our later detailed discussion in Section III of specific issues in intervention and an assessment of the relative advantages and disadvantages of each type of intervention.

We have found in past Commission rules and orders a wide range of actions that effect the marketplace of post-purchase remedies ("PPRs"). In all of its activities regarding PPRs, the Commission is only one of several agents -- the marketplace, the legislatures, the courts -- that define the PPR landscape. Like those other agents, the Commission can intervene in three basic ways: 1) by providing information; 2) by adjudicating and enforcing liability under existing PPRs; 3) by requiring PPRs in contracts. Other agents may also set product standards.

The Commission has influenced how PPRs are set and how they are enforced both indirectly and directly. The Commission acts indirectly to influence PPRs when it requires disclosure of information that will likely affect consumers' demand for PPR terms in their purchases, as in disclosure of the rate of success achieved by past purchasers of a service (*e.g.*, idea promotion, vocational schools). Direct influence of PPRs is achieved when the agency sets contract terms, such as the Negative Option rule provision setting 10 days as the minimum time to decline a purchase under a book-club type plan.

The taxonomy that we have selected for our analysis looks like this in outline (with illustrative examples in parentheses):

A. INFORMATION

  1. Information about product/service risks
  2. Information about the contract's PPRs
    a. Pre-sale (warranty disclosures)
    b. Post-sale (detailed disclosure of warranty enforcement procedure; cooling-off notice and form)
  3. Information about sellers' performance under PPRs

B. ENFORCEMENT OF EXISTING PPRs

  1. Promoting private enforcement
    a. Procedural measures (encouraging informal dispute resolution procedures)
    b. Defining performance standards (30-day rule for mail order delivery)
  2. Direct FTC enforcement (rules and orders compelling performance)

C. REQUIREMENTS FOR PPRs

  1. Mandated - Cooling-off, trial period, refunds, warranties
  2. Optional - The PPR term is suggested in the sale, but need not be offered or purchased.

D. [PRODUCT STANDARDS - Not used by FTC]

What follows is an elaboration of this taxonomy, with examples from Commission rules and orders of each type of intervention. We also note how FTC interventions interact with the market and legal systems, how they operate, and generally how intrusive they are considered.

A. INFORMATION

1. Information about risks

The Consumer Information Remedies briefing book 1/ (referred to throughout this book as "CIR") describes in detail the Commission's programs and policies in providing consumer information. Much of this activity is aimed at giving consumers data about product risks, and is required where failure to disclose the material information about risk would be deceptive or unfair.

To the consumer considering a purchase, PPRs are first suggested in the search for information about the level of risk or uncertainty associated with the purchase. 2/ Is the product or service inherently risky regarding future performance? How great is this risk? Is the degree of risk known? What are failures likely to cost? The consumer's own previous experience with similar commodities, advertising, and sales representations about risks all interact with the consumer's particular inclinations to assume or avoid

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1/ Office of Policy Planning, June, 1979.

2/ The Overview, Section II.A., describes PPRs as contract terms that insure the buyer against all or part of the risk associated with a purchase. These and other insurance concepts are used throughout this report.

risks. Demand for risk information interacts with an individual's perceptions and attitudes about risk in complex ways. The following Overview section describes in greater detail how information about risk is generated and how risk is allocated in the market.

Product information disclosed by sellers voluntarily or under FTC rules or orders can either reduce the risk or help consumers evaluate it. Care labelling disclosures for garments 3/ reduce risk, that is, the risk that the product will be damaged by improper cleaning. Disclosure of the condition of a used car reduces risk as well, for even if the disclosure is that the car has some defect and repair costs must be anticipated, these can be accounted for in the price the consumer is willing to pay. 4/ Similarly, for consumers considering buying long-term contracts that have an expected benefit only at the end, like vocational school courses, then information about drop-out rates helps them to evaluate the risk before obligating themselves. 5/

Policing deceptive information about risk and PPRs is another FTC function. Claims that treatments "cure baldness"

3/ Care Labelling of Textile Weaving Apparel, 16 CFR 423 (1980).

4/ (Proposed) Used Motor Vehicle Sales TRR, 16 CFR 455. See Staff Report, Sept. 1978.

5/ Proprietary Vocational and Home Study Schools, 16 CFR 438 (1980).

imply that they do it in 100% of the cases. Disclosure that it works in only some fraction of treatments gives potential buyers a non-deceptive evaluation of that risk. 6/ Similarly, disclosures the Commission has required in orders entered against an invention promotion firm about it's past success in marketing helps potential clients to assess their risks. 7/

Information about risk is generally less intrusive than other interventions because it leaves to the market the means of reducing that risk in the most efficient way; yet information may or may not be the most effective way to remedy a problem in every case.

2. Information about the PPRs offered

a. Pre-purchase

Consumer search costs for the best purchase can also be lowered by providing information about the PPRs offered in the market. One way the FTC can improve the market is to promote the production of the information in ways that the market fails to do. Such information is designed to meet consumers' perceived risk -- it describes how a contract reduces that risk, by how much, and implicitly at what price. The Commission can also make the information more useful, for example, by ensuring that warranty information

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6/ Ward Laboratories, Inc. v. Federal Trade Commission, 276 F.2d 952 (2nd Cir. 1960), cert. denied, 364 U.S. 827 (1960).

7/ Idea Research and Development, Inc., 89 FTC 31 (1979).

is available before sale, 8/ that warranties and other contracts are written in plain English, 9/ and that contracts are provided in the same language in which the transaction is negotiated. 10/

Another important FTC function -- and perhaps its most important function regarding PPRs until very recently -- is to police the accuracy of sellers' representations about PPRs, particularly in advertising. Here the Commission works to maintain accurate consumer expectations about the content and value of contract PPRs. Deception in warranty advertising occurs when consumers viewing the ad are left with the impression that the warranty terms assign more of the risk to the seller than they actually do. The Commission has brought numerous cases against firms advertising "unconditional" guarantees when the contracts specified many preconditions and in fact left much of the risk of product defects to consumers. 11/ In some instances, the Commission may even seek to ban particular clauses or terms from PPR contracts because they are inherently deceptive--for example, where one clause makes the entire PPR of little or no actual value. 12/

8/ Rule 16 CFR 702 establishes requirements for stores, mail order sellers and door-to-door sellers to make the texts of warranties on consumer products available to shoppers.

9/ Disclosure of Written Consumer Product Warranty Terms and Conditions, 16 CFR 701 (1980).

10/ Cooling-Off Period for Door-to-Door Sales, 16 CFR 429 (1980).

11/ Sibco Products, Inc., 68 FTC 892 (1965); Accro Watch Co., 68 FTC 378 (1965).

12/ Skyline Corp., 85 FTC 444 (1975). This firm's mobile home warranty required the buyer to return the home to the factory for warranty repairs.

b. Post-purchase

After the purchase is made, consumers need additional information about the PPRs in the contract: what they must do to qualify (e.g., follow maintenance procedures, use properly), how to secure the remedy (e.g., bring defective product to seller, contact manufacturer). Warranty disclosures under Magnuson-Moss rules must include a step-by-step description of the procedure for enforcing the warranty. Of course, this information also has relevance pre-purchase. A very different sharing of risks occurs under a warranty that provides in-home service as opposed to one that requires the consumer to ship the defective unit to the factory for repairs. It is also relevant to know before purchase whether the warrantor offers some form of arbitration or other third-party procedure to resolve contract disputes -- or, stated another way, some method to insure the buyer against the risk of non-performance under the contract PPR terms.

Full disclosure and simple language 13/ are the approaches used here by the Commission. Convenience in exercising post-purchase rights can also be a goal -- the rules and orders with a cooling-off PPR require that the seller give contract signers a pre-printed form for easy exercise of the cancellation right. 14/

13/ Warranty terms, conditions, buyer duties and enforcement procedures must be detailed in consumer product warranties under 16 CFR 701 (1980).

14/ See, e.g., 16 CFR 429.1 (1980); Soundtrack Chevell Industries, Inc., et al., 88 FTC 517,525 (1976).

Overall, these information approaches are potentially the least intrusive of Commission interventions regarding PPRs. They provide information about remedies that sellers already offer, and the costs of full and effective disclosure are often minimal. Moreover, information in general -- about risk as well as pre-sale and post-sale information about contract PPRs -- is the least intrusive type of remedy because it permits the market to select the PPRs.

B. ENFORCEMENT OF EXISTING PPRs

Whether PPRs are set by statute, rule or contract, there remains the question of enforcing the contract. Contracts can rarely specify every conceivable contingency; enforcement often involves having a court or some equivalent agent judge the facts when a problem or dispute arises. The market's function here is to generate information about which firms live up to their contracts and which ones balk or do not at all; this usually appears as general information about firms' reputations, or goodwill. The market may also provide third-party dispute resolution schemes.

Courts stand ready to enforce contracts -- in fact, this is a principal function of common law courts. But today access to court is restricted to the most expensive contract cases, largely because of the high cost of lawyers and the costs imposed by courts' rules of practice and evidence. 15/

15/ See discussion of this in Enforcing PPR Performance, Section III.C.

Two ways the Commission acts to remedy this problem are 1) indirectly, by making private enforcement actions easier to bring procedurally, e.g., by lowering the costs, and 2) by directly policing firms' performance under their contracts, and bringing Commission enforcement actions against those that do not perform adequately.

1. Promoting private enforcement

Consumer dispute resolution mechanisms ("CDRMs") that have some power to enforce their own decisions 16/ are low-cost alternatives to courts. They provide an indirect way for the FTC to act, because it is the power of the mechanism that actually enforces the contract. Actions taken by the Commission to encourage firms to establish CDRMs promote private enforcement of contract PPR terms, yet do not intrude on the market, which creates the CDRMs.

The Holder Rule also works indirectly. 17/ It permits an aggrieved buyer to raise a liability issue as a defense or counterclaim in a suit over a debt held by a third-party creditor; this is obviously less expensive than having the consumer litigate the dispute, such as a warranty dispute, over the same transaction in a separate lawsuit against the seller.

16/ FTC Rule 16 CFR 703 requires that firms show "good faith" in abiding by CDRM decisions, subject to pending FTC audit. In many states an arbitrator's decision is enforceable in court; having a final decision already makes the court procedure easier for plaintiffs than bringing a case directly to trial.

17/ Preservation of Consumers' Claims and Defenses, 16 CFR 433 (1979). The "Holder Rule" does not create any new liability; rather it makes a third party (the creditor) liable for the PPR terms of the contract between the seller and the buyer. A similar procedure is available for third-party credit card purchases under the Fair Credit Billing Act, 15 USC 1666, and the Regulations under that Act, 12 CFR 226.7 (1980).

A final indirect intervention to aid private enforcement is requirements for clear seller disclosure of contract terms that may be crucial in any subsequent dispute over product or service quality. It is obvious that specific, written contract terms reduce the chances of post-purchase dispute; yet consumers may be comforted with oral seller promises. Interventions that set quality and PPR terms in the contract make it easier for aggrieved buyers to hold sellers to their sales representations. This is the result of such information disclosure rules as the R-Value rule for insulating capacity 18/ and the Used Car rule for quality and warranty terms. 19/

2. FTC enforcement

The Commission can enforce contract PPR terms directly with its authority to enforce its rules and orders. Any Commission rule or order that requires sellers to perform PPRs places the Commission in the role of secondary enforcer (after the buyer seeking private enforcement) of the PPRs. This is especially important where private enforcement is impractical.

The Commission's rules concerning Mail Order Merchandise, 20/ Negative Options 21/, and Franchises 22/ compel refunds under

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18/ Labeling and Advertising of Home Insulation, 16 CFR 460 (1980).

19/ Notice of Proposed Rulemaking, Sale of Used Motor Vehicles, 41 Fed. Reg. 1089 (November 6, 1976).

20/ Mail Order Merchandise, 16 CFR 435 (1980).

21/ Use of Negative Option Plans By Sellers in Commerce, 16 CFR 425 (1980).

22/ Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 CFR 436 (1980).

under certain circumstances. One Commission order compels a firm to cease and desist from advertising a money-back guarantee "unless the refunds are made in a timely fashion in virtually every instance". 23/ A number of other orders compel full satisfaction of warranty claims. 24/

Orders concerning defective products brought under Section 5 of the FTC Act put the Commission in direct line to enforce the remedy to repair, replace or reimburse. The Commission has entered orders under which firms have given refunds for defective crash helmets 25/ and repaired defective heat pumps 26/ and cars. 27/

All redress orders brought under Section 19 enforce statutory or common law PPRs to remedy seller "dishonest and fraudulent" practices. 28/ The credit balance cases required credit card firms to refund monies which belonged by law to their customers. 29/ In the repossession surplus cases, 30/

23/ *Jay Norris Corp., et al.*, 91 FTC 751, 836 (1978), *modified* 598 F.2d (2nd Cir., 1979).

24/ *Capital Mfg. Corp.*, 73 FTC 872 (1968); *Skyline Corporation*, 85 FTC 444 (1975); *The Commodore Corporation*, 85 FTC 472 (1975), Redman Industries, Inc., 85 FTC 309 (1975); *Fleetwood Enterprises*, 85 FTC 414 (1975).

25/ *Pay Less Drug Stores Northwest, Inc., et al.*, 82 FTC 1473 (1973).

26/ *Fedders Corp.*, 93 FTC 949 (1979).

27/ *Ford Motor Company* Docket No. 9105, 45 Fed. Reg. 13115 (February 28, 1980) (provisionally accepted order).

28/ 15 U.S.C. 57b.

29/ *Diners Club, Inc.*, 89 FTC 298 (1977); *Carte Blanche Corp.* 89 FTC 305 (1977); *Federated Department Stores* 89 FTC 313 (1977); *City Stores, Inc.*, 89 FTC 322 (1977); *Atlantic Richfield*, 89 FTC 330 (1977); *Hertz Corp.* 89 FTC 980 (1978).

30/ *Ford Motor Co.*, 93 FTC 402 (1979).

the Commission alleged that new car dealers and manufacturers' credit subsidiaries kept money that they were obliged under state law to return to defaulting customers. The orders in those cases require the firms prospectively to obey the state law rule that fixes this refund PPR term. 31/

Other PPRs in this group define with greater specificity the liability rules that apply by law to the transaction. This defining function is perhaps the most significant activity in PPRs in which the Commission has been active to date, judging by the number of transactions covered.

The following are examples of the Commission use of rules to define PPR standards:

- *Mail order rule* -- This rule sets a time limit for delivery of goods at 30 days where the contract does not specify one; but it allows the parties to expressly agree to extend the time. 32/
- *Negative option rule* -- One feature of this rule is to ensure that enrollees in book and record "clubs" have a minimum number of days to exercise their option to decline a purchase. 33/ This term is mandated and may not be reduced in the contract.

31/ UCC §9-501-507 (1980).

32/ Mail Order Merchandise, 16 CFR 435 (1980).

33/ Use of Negative Option Plan By Sellers in Commerce, 16 CFR 425 (1980).

These rules give the kinds of specific definitions to liability standards that the common law would give on a case-by-case basis, by the time-honored process of supplying the missing (implied) terms of a contract on the basis of what is reasonable. The courts' common law decisions do not bind other parties and future contracts, and the common law rules do not always become an explicit universal standard in future contracts -- it is left to the market to adopt the standard. When it does not, individual buyers are not in fact protected by the common law standard, because it is too costly to litigate each case. However, in the above two instances, the Commission has particularized the issue of "what is a reasonable time for performance" for two classes of contracts and made the common law standard a prospective rule for all such contracts.

Finally, the Commission can supplement the role the courts serve in enforcing PPRs by requiring non-judicial dispute resolution of PPR disputes. When a consumer dispute resolution mechanism ("CDRM") hears a dispute over a product failure, it often provides the same service as courts in supplying the missing terms of the contract: How long is a reasonable time to repair? How many irreparable defects make a "lemon"? Is the warranty extended if the product is out of use for a long time waiting for warranty repairs?

Commission orders requiring a CDRM include a furniture retailer 34/ and a new home developer. 35/

While these sorts of interventions are less intrusive in that they merely apply the standards of the common law and statutes to individual contracts, they can nonetheless be costly. Individually-crafted justice is expensive: rules of evidence, impartiality, and speed of decisions, while important values in providing justice, do come at a price. Hence, they too raise significant questions of costs and benefits.

C. REQUIREMENTS FOR PPRs

1. Mandatory PPRs

This group consists of all the Commission actions that actually fix the allocation of liability. The Commission goes beyond the contract that sellers and buyers have set, and what the common law specifies for that class of transactions, and mandates the risk sharing: this may cover particular industries or firms; for particular types of transactions (*e.g.*, door-to-door, mail order); or certain post-purchase contingencies (*e.g.*, the discovery of a design defect).

Requirements for PPRs range from mandating entire PPRs, such as warranties and refunds, to requiring that certain coverage be included in any market warranty or refund policy.

34/ *Walker-Thomas Furniture*, 87 FTC 26 (1976).

35/ *Kaufman & Broad*, 93 FTC 235 (1979).

This category, then, includes a requirement that a warranty offered include a particular feature of coverage, such as "all parts and labor", or a requirement that refunds be calculated by a specified formula.

One Commission order specifies a warranty on the materials supplied by a seller of pre-cut homebuilding kits. The order includes specification of the warranty coverage, duration, remedies and performance standards. 36/

Some of these liability standards serve an information function as well, and so they would fit as well in the information category above. In the cooling-off rule, for example, not only is the consumer who has signed the contract given time to "cool off" from the high pressure sales presentation, but that buyer also has additional time to gather more information about the seller, the product, prices, quality, risk, the PPRs, etc. Trial periods or opportunities to inspect, coupled with a right to refund, also have obvious information purposes. The order that gives buyers one year to visit resort property sites and cancel their purchase for a full refund if dissatisfied, gives these buyers a chance to gather further information about the land. 37/

36/ Lindal Cedar Homes, 87 FTC 8 (1976).

37/ Horizon Corporation, 3 CCH Trade Regulation Reporter ¶21,621, Docket No. 9017 (1979)(initial decision).

2. Optional PPRs

A variant on a requirement for a PPR term is a rule which would require a seller to offer the PPR at an additional price, but permit consumers to choose whether to pay for the PPR protection. This does not appear in any current Commission rules or orders, but is envisioned in the proposal supported by the Bureau of Consumer Protection in the proposed rule on the Sale of Used Motor Vehicles. 38/ There, a required window sticker posted on the car provides a place for the seller to report on the vehicle's condition (defects) and warranty terms, and contains specific caveats to the consumer to the effect that the seller's oral statements of condition and the warranties may not be enforceable. But the seller need not do the inspection or offer any prospective warranty. The net effect of these optional PPRs is to facilitate buyer-seller negotiation of the PPR terms and price.

This approach to PPRs overlaps considerably with an information approach in that it emphasizes disclosure of the PPR option (inspection plus warranty). It also has benefits for reducing the costs of private enforcement, to the extent that it encourages buyers to insist on written statements instead of the difficult to prove (and thus unenforceable) spoken promises commonly made by sellers. We place it here in the catalog because it has been considered as an option to mandating PPRs.

38/ Notice of Proposed Rulemaking, Sale of Used Motor Vehicles 41 Fed. Reg. 1089 (November 6, 1976; memorandum of Albert Kramer, Director Bureau of Consumer Protection to Commission, July 26, 1979.

D. SETTING PRODUCT STANDARDS

The Commission has never set product standards, although this approach is widely used by other agents. Legislatures and agencies set product standards for safety and health, including auto design standards for seat belts and pollution control, safe food and drug standards, and so on. The market also sets product standards through private standard setting organizations and certifiers. Because product standards are a very intrusive remedy -- they prohibit the sale of non-complying products -- they are generally not suited to the kinds of economic injuries with which the Commission is largely concerned.

E. SUMMARY

In summary, then, the Commission has at its disposal a broad range of approaches to PPR problems: information, enforcement of existing PPRs, and requiring PPRs. Information remedies add to the data available in the market that bear on market decisions regarding PPRs. Enforcement measures can be taken directly, or indirectly by encouraging private enforcement. Requiring PPRs can be done with mandatory standards, or by requiring sellers to offer an optional term with its own price.

The impact and effectiveness of each of these possible Commission interventions can be best understood with an appreciation of the market economics of risk, risk sharing, and risk reduction -- in short, the economics of insurance. We turn to these subjects in the following Overview Section.

II. OVERVIEW

A. POST-PURCHASE REMEDIES IN THE MARKET

1. Introduction

This section discusses the economic theory of post-purchase remedies, or PPRs. By PPRs in this context, we mean the entire spectrum of possible contractual remedies to unsatisfactory product or service performance 39/, including warranties, service contracts, cooling-off provisions, trial periods, refunds terms, and so on. It is important to recognize from the outset that the term is not limited to the remedies provisions of FTC rules and orders; rather we use the term PPRs in its broader sense of contractual remedy terms observable in the marketplace. When we turn later to consider the Commission's options we will refer to them as "interventions," and some (but not all) of these will be to require in rules and orders the same post-purchase remedy clauses found elsewhere in the market. For example, the rule on door-to-door sales imposes a cooling-off PPR.

Since virtually all PPRs appear in some form in markets where they are not required by any law, it appears that there are market forces that create a demand for PPRs and a market response by sellers to this demand that places the PPR terms in sales contracts. Analyzing these market forces

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39/ Performance is meant to be interpreted broadly here. Aspects of performance include: is the product (or service) free of defects? Does it fulfill consumers' expectations about its suitability for the purposes for which it was purchased? Is the product reliable?; etc.

and the constraints under which they operate is therefore essential to understanding the causes of failures in the marketplace that require Commission intervention. In this section, we analyze the market for PPRs and the market failures regarding PPRs. Later, in Section III, we turn to consider the spectrum of options for Commission intervention.

In our introductory discussion here of the market forces that shape marketplace PPRs, we assume throughout that the market is a reasonably competitive one.

2. Risk and uncertainty in the marketplace

Two features of PPRs are critical to an understanding of the market response to the demand for PPRs. First, PPRs will arise in the marketplace only where there is some risk or uncertainty about product or service performance. Market-provided PPRs are a response to that uncertainty: they are forms of insurance offered by the seller to the purchaser against unsatisfactory post-purchase performance. The other critical feature is that PPRs are often offered only as a tie-in with the product they cover. Product warranties are available only from the manufacturer or seller and the price is implicit in the sale price. 40/ This tie-in aspect

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40/ An exception to this is service contracts, warranty-like policies of prepaid repair insurance sometimes offered by independent repair shops. Many service contracts are sold by the manufacturer or seller at the time the covered product is sold, but this is not necessarily the case.

distinguishes PPRs from explicit insurance policies sold in the market, like homeowners fire insurance and automobile accident insurance. In our economic analysis, PPRs are viewed as a form of tied-in insurance. 41/

There are several possible sources of uncertainty, or risk, that affect the level of consumer demand for the insurance of PPRs. These are uncertainty about 1) product or service performance; 2) the substance of the PPR protection offered by the seller; and 3) the seller's ability and interest in performing fully according to the contract's PPRs. Sellers may also be somewhat uncertain about product performance; more important to them will usually be the uncertainty about the way their customers will affect the risk they, the seller, assume under the PPRs. We turn now to consider these market uncertainties in this order.

a. Uncertainty about product or service performance

Consumers are concerned about the uncertainty of product or service performance for obvious reasons: they do not want to be stuck with a bad bargain. Sellers' concern about uncertain product or service performance arises from four sources: (1) the effect on the price they can charge; (2) the importance of goodwill; (3) the liability assumed by them under the PPR offered; and (4) the potential legal liability for unsatisfactory performance.

41/ This is not to suggest that they are insurance contracts in a legal sense.

Product or service performance may be uncertain for a number of reasons that depend on the type of product, type of seller, and type of buyer. First, the unit purchased may break down or in some other way fail to perform in the manner promised by the seller or otherwise expected by the consumer. No product lasts forever and the various measures of the durability and reliability of the item purchased may be unknown to the consumer at the time of purchase. Second, even if the item objectively performs as expected, it may not provide the subjective performance level expected by the consumer. For example, a washing machine may satisfy the specifications disclosed in advertising and be free of defects, but not clean clothes to the buyer's satisfaction. With services, buyer dissatisfaction may come from a variety of objective and subjective factors.

Some uncertainty is faced by both buyers and sellers. A seller generally knows no better than the buyer which particular units will fail. 42/ However, the seller would generally have better information about the average breakdown rate than buyers. Sellers' information should be fairly good in this regard, except for new products with which sellers themselves have little experience.

In addition to uncertainty about product or service performance, there are other important sources of uncertainty to which the market may respond.

42/ An exception would be where sellers regularly inspect or otherwise determine the quality of individual units, as was found to be the case in the sale of used cars by dealers. See, Staff Report, Sale of Used Motor Vehicles (September, 1978) at 71 ff.

b. Uncertainty about substance of PPRs

The buyer may also be unsure about the coverage, scope and adequacy of the PPRs themselves. This could be due to high pressure or deceptive sales techniques, poorly drafted advertising, unreadable contracts, deceptive contract PPR terms, or lack of understanding of or interest in the provisions. The consumer can reduce this uncertainty by closely examining the available PPRs, demanding better explanations of terms, and purchasing only products with clear and comprehensible PPRs. The seller can reduce this uncertainty by making available more readable contracts, educating sales personnel, and by designing creative advertisements that communicate the nature of PPRs effectively. As with product performance uncertainty, the market-perfecting role of information may also serve a self-correcting role here. 43/

c. Uncertainty about sellers' performance of PPRs

The consumer may be uncertain about the ability and interest of the seller to fulfill duties under the contract PPRs. This uncertainty is closely related to uncertainty about the PPRs themselves, of course. The consumer may be able to reduce this uncertainty by gathering information about sellers' post-purchase behavior, most likely in the form of general information about reputation.

43/ See, CIR briefing book, pp. 46-47 (edited version).

d. Seller uncertainty about buyers

Sellers also operate in an environment of uncertainty, but of a different sort. They will be uncertain about the characteristics of buyers that affect the likelihood of product breakdown, such as how well they care for and maintain the product and how intensely they use it. The seller will want to know these buyer characteristics in choosing PPRs and setting a price for them.

Generally sellers of consumer products and services have information only about the average levels of these buyer characteristics, not the characteristics of any particular consumer. As we discuss below under the rubrics of adverse selection and moral hazard, this informational limitation may restrict the seller's ability to offer a comprehensive PPR. To explain these concepts briefly here, any seller that offers broader PPR coverage than competitors may attract more than an ordinary share of buyers who are heavy users or do not perform required maintenance. And when any one or all sellers broaden coverage, they may reduce consumer incentives to do proper maintenance. There are techniques that insurance companies use to manage such "high risk" liability: deductible and co-insurance clauses, gathering information on buyer characteristics, and setting up risk groups with premiums set accordingly. However, these insurance risk-management techniques may be too costly to apply to the PPRs of consumer goods and services, and so the PPR offerings in the market may be limited to sellers assuming only a small portion of the risk.

Sellers also face uncertainty about buyers' preferences for PPRs. Since PPRs are not explicitly negotiated in most consumer transactions, the seller must discover buyer preferences through market research and experimentation. Sellers sometimes offer different bundles of goods-plus-PPRs at different prices in order to have an offering to attract consumers with different characteristics and preferences. Sometimes firms will offer different PPR terms with various models of a particular product. Tires and batteries are two products commonly marketed in this manner.

3. Marketplace protection from risk and uncertainty

As just discussed, the buyer and seller in a transaction face the mutual risk of product failure and a number of uncertainties. The buyer and seller each have an interest in shedding that risk and uncertainty. Each has two methods available. First, buyers and sellers may lower the risk in the transaction by taking unilateral action: gathering additional information about the likelihood of product failure; and reducing that risk of product failure by prevention activities such as preventative maintenance, more careful quality control, and greater care in use. Second, each may attempt to reduce the risk he personally faces by shifting it to the other contracting party.

As stated previously, the major consumer benefit of a PPR lies in its insurance function; consumers shift risks to sellers by purchasing a PPR as insurance. Of course, the seller sheds himself of risk by refusing to offer that insurance, and leaving the risk with the buyer. Consumers can accept those risks or seek a seller who will assume them, or decline to make a purchase that is perceived as too risky.

a. Incentive compatibility and failure prevention function of PPRs

At the same time the PPR provides insurance, the allocation of risk under the PPR has the indirect effect of altering the incentives each party has for reducing risk unilaterally by failure prevention activities. Buyers and sellers recognize this indirect effect and attempt to exploit it by designing PPRs that are compatible with economic incentives to prevent failures. The more "incentive compatible" is a PPR, the lower will be the total risk shared by the two parties. At the same time, the desire for incentive compatibility may limit the amount of risk that may be shifted to the other party, or it may require certain obligations or burdens by either party. These limitations have been studied in the economics literature under the misnamed rubric of "moral hazard" problems. 44/

44/ J.P. Brown, "Toward an Economic Theory of Liability," 2 Journal of Legal Studies 323 (1973)(hereinafter cited as "Brown"); S. Salop, "Parables of Information Transmission in Markets," The Effect of Information on Consumer and Market Behavior, edited by A. Mitchell (American Marketing Association 1978)(hereinafter cited as "Salop"); M.V. Pauly, "The Economics of Moral Hazard: Comment," 58 American Economic Review 531-37 (June 1968); S. Cheung "Transaction Costs, Risk Aversion and the Choice of Contractual Arrangement," 12 Journal of Law and Economics 23-42 (1969); M. Spence, "Consumer Misperceptions, Product Failure and Producer Liability," Review of Economic Studies 561-72 (October 1977)(hereinafter cited as "Spence"); D. Scheffman and E. Applebaum, "Product Reliability, Warranties and Product Liability, and Advertising," (unpublished 1980)(hereinafter cited as "Scheffman and Applebaum").

As regards failure prevention by the buyer, an incentive compatible PPR would induce a high level of care by the buyer. Product warranties do this by excluding coverage of failures due to owner abuse or lack of maintenance. As a general matter, the greater the degree of risk borne by the buyer, the greater will be the level of care thus induced. On the other hand, certain types of risk cannot be reduced by greater care, and higher care may not be induced in spite of the increased incentive in some cases. No amount of buyer care can prevent a latent defect in a product that is caused by improper manufacture.

Similarly, an incentive compatible PPR attempts to induce failure prevention by the seller as well. If the seller is liable for a risk, he will have a greater incentive to reduce or eliminate it. As with buyers, the general incentive of a seller to prevent failure depends on the degree of risk assumed. A seller can reduce risk of failure or consumer dissatisfaction by improving product design and reliability, or by marketing products and services in a way that does not induce buyers to have unreasonable post-purchase expectations.

b. Risk shifting function of PPRs

Not all risks should clearly be laid to the buyer or the seller to maximize risk reduction; some risks could go to either party on that basis. These remaining risks are sorted in the marketplace according to which party is more willing to bear the risk, and at what price.

In a market context, the willingness of a consumer to pay to shift risks to the seller can be measured as the price premium the consumer is willing to pay for any additional PPR protection. This can be labelled the "consumer demand price" for the PPR. Some of the factors reflected in this price are the expected costs for repairs or other remedies, the expected likelihood of failure, and the premium the consumer is willing to pay to be relieved of the risk. This last factor, termed "risk aversion" depends on such individual factors as personal wealth and attitudes toward risk. Individual consumers may vary considerably along these lines, and thus may prefer broader or narrower PPRs.

Sellers will offer a PPR where the cost of doing so, termed "market supply price", equals the consumer demand price. Sellers costs depend largely on their expected costs of repair, which includes the costs of administering a warranty system or other PPR performance. Sellers may also be more or less averse to risk, depending on the size of the risk compared to firm assets, and the range of variability of the risk. 45/

c. Adverse selection

The ability of the buyer and seller to design an incentive compatible, well-tailored PPR is limited in a number of ways. First, in a consumer market context, it is too expensive to bargain over the terms of each transaction, and as a

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45/ We consider the issue of demand and market supply prices in the context of mandating PPRs in Section III.E., below.

result, the seller may offer little or no choice in PPR coverage. Many products and services are thus sold with a standard contract and PPR terms because this is the cheapest and most efficient way.

Second, even if the contracts were individually negotiated, the seller or buyer may misrepresent his characteristics in order to strike a better bargain. Every buyer and seller has an incentive to claim he takes a high level of care or is otherwise less likely to experience product failure, if this cannot be monitored by the other party. For example, in health insurance, if insurers were to offer lower rates to all consumers who claimed they were healthy, they would attract unhealthy buyers as well. (Instead, lower rates are offered only to people who are young or who undergo an examination and review of their medical history, or who for some other reason can be predicted to fall within some low risk group.)

This issue has been studied in the economics literature under the term "adverse selection." Adverse selection may eliminate all PPR coverage, just as adverse selection destroys the used car market in Akerlof's "lemons equilibrium." 46/ In a market context, adverse selection may also be dealt with by offering choices that sort out buyers according to

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46/ G. Akerlof, "The Market for Lemons: Qualitative Uncertainty and the Market Mechanisms," 84 Quarterly Journal of Economics 488 (August, 1970) (hereinafter cited as "Akerlof").

their likelihood of causing product failure, if carefully designed PPR choices can be offered at prices that reflect this likelihood. For example, given a choice over deductibles, since low deductible auto insurance is likely to be purchased by drivers more likely to have accidents (as well as those who dislike risk more), an insurance company will price the low deductible accordingly, taking into account this induced selection by the high risk drivers 47/

Sellers may also deal with the adverse selection problem by gathering information about prospective buyers before purchase and only offering the product or certain PPR protections to some prospective buyers. Sellers use screening devices such as employment history and even zip codes in setting insurance and loan rates; these screening devices vary in their precision, in the sense that less perfect screening devices misclassify more buyers. Sellers will do more or less screening according to the risk they bear. For example, if landlords are required to give tenants greater length notice prior to eviction, they will have an incentive to screen prospective tenants more carefully in order to select those who are financially able and willing to make rental payments.

For consumers, the situation with regard to adverse selection is symmetric. They cannot necessarily distinguish among the sellers in a market which of them is more likely

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47/ A famous example of judicious contractual choice is King Solomon's proposal to cut the baby in half, causing the false and true mother to each reveal her true identity. Of course, the false mother was unsophisticated; she should have lied!

to perform the promises made in the PPR terms. Buyers may gather information about sellers before purchase, use screening devices like time in business and market share, and purchase repeatedly from sellers who build goodwill by offering satisfactory products and PPR performance. Or, a buyer can demand PPRs that are designed to deal with possible seller adverse selection problems, for example, by demanding seller precommitment to a third-party dispute resolution mechanism.

In summary then, a buyer and seller in a transaction each have an interest in designing incentive compatible PPRs that induce efficient failure prevention and allocate risk according to the parties' relative willingness to bear those risks. This desire for incentive compatibility may limit the freedom of the parties to shed as much risk as they may like. At the same time, the potential for adverse selection may also limit the amount of risk sellers assume; in extreme cases, potential adverse selection may eliminate the availability of PPRs entirely, if no satisfactory PPR can be designed to overcome the problem.

d. Self-enforcement costs and goodwill

All PPRs are somewhat costly to enforce. Even if there is no need to litigate the dispute, 48/ the product often must be returned to the seller for repair or replacement.

48/ This discussion considers self-enforcement costs only; we turn to consider the limitations imposed on market functioning by the costs of enforcing through the legal system in Section II.B., below.

There are always some costs for time and inconvenience; some PPRs, such as limited warranties, may put part of the repair costs on the consumer. As a result, buyers will not find it in their interest to pursue small claims. If enforcement costs are sufficiently high, due either to seller recalcitrance or simply to the necessary costs of transacting, PPR protections will be virtually worthless.

If buyers are aware of these costs and the limitations they place on effective protection, they will discount the value of the PPR accordingly. This in turn reduces consumers' demand for the PPR, and thus limits the degree of PPR protection offered in the market. On the other hand, if the costs are due to unforseen seller non-performance or the costs are misunderstood or deceptively hidden, then the buyer may overestimate the value of the PPR. If enforcement costs were reduced or consumer perceptions were corrected, the market would perform more efficiently.

Even where legal enforcement costs under the PPR are high, if a significant number of buyers are aware of a seller's performance, the market will enforce the contract. Sellers need to maintain a level of performance that builds goodwill, in order to attract both repeat purchasers and new customers who learn from experienced buyers. In this sense, the fear of lost sales in the future raises the seller's gain from satisfactory performance, even though buyers may have no effective legal recourse for non-performance. This is, of course, similar to the manner in which a competitive market enforces a high level of product quality through the collective decisions of informed buyers.

e. Third party contractual agents

A final way in which the market may reduce risks for consumers of poor product performance or seller non-performance of PPRs is through the efforts of third party contractual agents. These agents have a number of possible functions, including collecting and disseminating information about product reliability and PPR performance, negotiating favorable PPRs for buyers, and enforcing PPRs by establishing consumer dispute resolution mechanisms.

One notable example is the American Automobile Association's experimental auto repair program. AAA certifies those repair shops that satisfy certain standards (*e.g.*, number of certified mechanics) and that agree to an AAA-designed auto repair contract. This contract includes provisions covering the return of old parts and an agreement by the shop to dispute resolution by AAA. This preferred contract is made available automatically to AAA members, although all consumers benefit from the signal inherent in the certification and access to the dispute resolution mechanism. 49/

The marketplace use of third party contractual agents is not new. Intermediaries such as architects and attorneys have always fulfilled the role of negotiating, enforcing and resolving disputes regarding contracts and PPRs. However, as the increased cost of individually-tailored bargains

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49/ This latter feature is not well-publicized however. A copy of the AAA-repair shop agreement is reproduced in Appendix D.

necessitates standard form contracts, and as buyers become more sophisticated, one might expect an increase in the importance of such contractual agents.

By representing a fairly large but relatively homogeneous group of prospective buyers, such an agent could exploit scale economies in negotiating preferred PPRs for members. Like the AAA program, this agency function might be packaged with other consumer services, or it might exist only for the purpose of negotiating services for its members, as is the case in buying clubs.

Industry groups well situated to enter this emerging industry are credit card companies and, to a lesser extent, banks. Credit card companies currently have a role as intermediary to large numbers of buyers and sellers, permitting them easy access to and communication with potential clients. Moreover, they have recently been given new responsibility under The Fair Credit Billing Act. 50/ Under the holder-in-due course provision of the Act, credit card companies are prohibited from demanding payment on disputed charges and must bear certain other information and communication requirements with regard to disputed charges. Because disputes might center on express or implied warranties of the product or service, the Act effectively gives consumers an advantage in enforcing PPRs; for now consumers have both the product as well as the dollar proceeds of the transaction.

50/ 15 USC 1666 (1979); the procedures for resolving disputes are set out in 12 CFR 226.7 (1980). A more detailed description of the statute and its operation can be found in Consumer Financial Services Briefing Book, Office of Policy Planning (November 15, 1979).

As it stands now, as consumers begin to learn about and exercise their rights under the Act, the role of the credit card companies will also increase. For example, apparently the current practice of the companies is merely to debit the account of the seller and credit the account of the buyer for the disputed charge, make disclosures, and communicate the substance of the complaint to the seller, presumably by standard form. The credit card companies could take a more active role. For example, rather than remaining a passive communicator, they might aid resolution of the dispute, either informally or through a formal CDRM.

A second reason why the credit card companies are well suited for this role is that they can enforce the remedy terms easily. The companies have an easy remedy against sellers' non-performance in the form of debits against their accounts. On the other side, they have adequate remedies against non-performing buyers as well, including dropping the account and easy access to credit reporting systems.

As they expand their role, the function of transaction agent may become more attractive. Indeed, some companies have already taken on the roles of insurance agent and buying club, offering a variety of insurance options and general merchandise at reduced prices. In this role, they could go so far as to negotiate price discounts with national and local retailers, as they have done with respect to rental car firms, or even negotiate contractual provisions.

Two examples of provisions are precommittment to a specific dispute resolution mechanism or a superior warranty. Because the credit company will have access to excellent records regarding consumer complaints, they could also certify the performance of high quality firms or those that agree to a specified PPR contract. Information about poor performers could also be readily disseminated.

This scenario rests, of course, on increased use by consumers of their rights under the Fair Credit Billing Act. It is doubtful that the industry will take the lead in this area without demonstrated buyer support in the form of increased use of the Act. Available data on current use of the Act indicates that consumers are not widely aware of its procedures, despite notice requirements. 51/

New and emerging forms of legal practice, including pre-paid legal plans and clinics are potential entrants. Local consumer groups are another potential entrant. While these have the advantage of increased credibility, they have surprisingly taken little active interest in this area. The same is true of Consumers Union, which serves only as information agent. Indeed, CU has even been reluctant to allow its ratings to be used by retailers or advertisers.

51/ Federal Reserve Board, 1977 Consumer Credit Survey, at 41 and 43.

B. MARKET FAILURES

The preceding discussion assumes that the market in which PPRs are set is perfectly competitive. But the real world often is not. In particular, certain forms of market imperfections may lead sellers to produce goods with less than optimal reliability, or to offer PPRs which do not share risks efficiently. Either situation is termed a *market failure*. In this section we will describe several market imperfections which may lead to this type of market failure. The imperfections fall into three categories: (1) market structure problems, (2) information problems, and (3) significant transaction, negotiation, or enforcement costs.

1. Market structure problems

a. Monopoly in the product market

The oldest recognized potential source of market failure is non-competitive market structure. It is well known that a producer with market power will generally find it in his interest to restrict output and raise price (relative to the competitive level). Thus, a market characterized by monopoly -- unlike the ideal competitive market described in the preceding section -- will not lead to an optimal allocation of resources.

However, economic theory does not predict that a monopolist will necessarily produce a product with less than optimal reliability, or offer PPRs that provide a less than optimal allocation of risks. That is, we do not know whether a noncompetitive market structure will lead to problems which call for intervention to increase PPR protection for buyers. It was formerly believed that monopolists would have an incentive to restrict product reliability (and to restrict the scope of coverage of their voluntary PPRs), for the same reason that they have an incentive to restrict product output. Recent literature however, casts considerable doubt on this view. 52/ The reason for this doubt is that -- as long as there are no information problems 53/ -- production of a less than optimal product or an inefficient PPR will reduce the amount that consumers are willing to pay for the product/PPR package. The monopolist will often be better advised to produce the exact product/PPR combination that consumers value most, and then extract monopoly profits by charging them the highest possible monopoly price for it. In sum, a monopolist may produce a product that is either more or less reliable than the efficient level.

52/ Swan has shown that a monopolist may have incentives to produce a product exactly as durable as would a competitive industry. Swan, The Durability of Good and the Regulation of Monopoly", Bell J., 347-357, (1971). Similarly, Scheffman and Appelbaum show that a monopolist may provide the same combination of product reliability and PPR as would a perfectly competitive industry. op cit. For a recent survey of the economic literature on this point, see R. Schmalensee, "Market Structure, Durability and Quality: A Selective Survey", Economic Inquiry 177-196 (1979).

53/ The effect of information problems -- a separate category of market failure -- is discussed below in Section II.B.3.

Thus, the economic case for intervention in this context is quite different from the economic basis for antitrust actions. Economic theory predicts unambiguously that a seller with market power will sell his product at a supracompetitive price. We cannot say, however, that a seller with market power will necessarily supply an inefficiently reliable product or offer an inefficient PPR.

b. Monopoly in the PPR market

The preceding subsection focused on a monopoly over the product being sold. In some cases, though, there may be many sellers of the product in question, but each seller may retain a monopoly over the PPRs offered in connection with his product. That is, the PPR may be offered solely as a tie-in: the only source for a warranty or trial period (or other PPR) for a particular brand of product will be the manufacturer or seller of that brand. In some cases, consumers may have more options; for example, service contracts for automobiles are now being offered by third parties as well as by the manufacturer. However, more commonly the only source for a PPR is the manufacturer of the product to be covered.

This form of monopoly does not indicate a market failure, though. As long as there are competing sellers of the underlying product (and there are no information problems), then competition to produce the most attractive product/PPR package as a whole should lead to the production of the optimal product and the most efficient PPR. This is true for the same reason that the practice of "tying" right shoes to left shoes does not produce inefficiencies in the production of left shoes: competition in selling the package as a whole is sufficient to assure that each component will be produced and priced efficiently.

Similarly, the fact that all sellers offer the same PPRs -- or that they offer them in a standard form contract over which they refuse to negotiate -- does not necessarily indicate a market failure. Just as a competitive market is expected to tend toward a uniform price, uniformity of PPRs could simply indicate that competition has forced all sellers to offer the exact PPR which consumers value most. Markets where sellers use standard forms and refuse to negotiate individually simply indicate that, in mass markets, the costs of individually negotiating every contract outweigh any gains that might be had from tailoring the contracts to each buyer's individual preference. As long as there are no other market imperfections, such as information problems, competition should still lead each seller to select the PPR which most buyers prefer. 54/

54/ Of course, uniformity of PPRs might also indicate that the sellers were colluding on their choice of PPRs. However, as we have seen, a monopolist may have no incentive to choose a suboptimal PPR, so collusion on PPRs is less likely to lead to suboptimal results in the sense that collusion on price would.

2. Transaction, negotiation, and enforcement costs

a. Transaction and negotiation costs

Transaction costs are another factor which may prevent even competitive markets from achieving a perfect allocation of resources. We have already seen one example of this: the cost of individually negotiating a contract with each consumer will prevent sellers from being able to tailor their PPRs to each consumer's individual preferences. Since PPRs (almost by definition) involve complex contractual arrangements, with many variables besides price and availability, 55/ they can not be sold as easily as selling a bushel of apples. Consequently, the cost of designing and negotiating PPRs will be a significant constraint on the ability of the PPR market to produce a perfectly satisfactory solution.

However, it is somewhat misleading to speak of this as a market imperfection. The costs of negotiating PPRs individually, for example, are still real economic costs, and they are no more an "imperfection" than is the fact that the cost of producing custom-built automobiles precludes every consumer from being able to have an individually-tailored vehicle at a reasonable price. Sellers will still have an incentive to provide the kinds of cars (or PPRs) which will satisfy consumers the most and they will offer different models and options to the extent that consumers are willing to pay for the costs of variation. Unless a way can be found to

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55/ Many of the provisions are required to deal with problems such as adverse selection and moral hazard, discussed below. See, also discussion in Brown, op cit.

actually reduce transaction costs by intervention, 56/ this result is the best that can be hoped for. The most likely possibility -- that intervention can reduce information costs -- is discussed in more detail below.

b. Enforcement costs

Enforcement costs are a slightly different matter. All PPRs -- in fact, all contractual promises of any sort -- depend for their value on the fact that they can be enforced, so that buyers have some assurance that the promises will be carried out. Even without any provision for enforcement, sellers might still adhere to their promises for fear of losing goodwill, but it is obviously in the interests of both buyers and sellers to have some mechanism by which they can offer a more binding commitment. 57/ Such commitments reduce the costs of enforcement and complement the self-correcting rule of goodwill.

Intervention to provide such a mechanism has already taken place, in the form of state contract law and the court system. However, this system has become so costly -- in time and effort, as well as in money -- that it is often unprofitable for consumers to attempt to enforce claims--even relatively large ones--except by threats of loss of

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56/ The private market sometimes attempts to overcome this type of transaction cost problem by inducing the formation of groups or clubs which fund an agent to negotiate for individual members of the group. The AAA certification of repair facilities and associated warranty agreement for AAA members is an example of this activity.

57/ For a general discussion of the role of goodwill in providing an incentive for proper seller performance, see Reich, "Toward a New Consumer Protection," 128 U. Pa. L. Rev. 1 (1979).

repeat purchases. This not only prevents consumers from receiving the benefit of their bargain; it also weakens or eliminates the incentives which PPRs provide to improve seller performance. If sellers are unlikely to be sued if their product breaks down in a minor way, then their incentive to take cost-effective steps to prevent such break-downs will be greatly reduced (except from fear of loss of goodwill).

In one sense, this form of market failure is the reason for creating agencies such as the FTC, to sue on behalf of consumers. Consolidation of consumer claims -- either by a public agency or by private class actions -- is one method of reducing enforcement costs. However, there may also be other forms of intervention which would reduce enforcement cost, such as the establishment of arbitration or other low-cost methods of dispute resolution as alternatives to the judicial system. Or, the Commission can disseminate information about PPR performance to increase the effectiveness of goodwill as a self-correcting device. All of these methods of reducing enforcement costs will be discussed in more detail later in the Interventions Section of this book (Section III.C.).

3. Information problems

a. Lack of consumer information

Even in the absence of transactions, negotiations, and enforcement costs, markets will have difficulty allocating resources efficiently if agents do not possess complete and accurate information on the reliability of the product, the terms of the PPR and the expected peformance of sellers under the PPR. This problem was fairly completely described in the CIR briefing book, so that we will only touch on it briefly here. 58/ A particular problem relating to PPRs which we will discuss here is the presence of informational asymmetries--specifically, the fact that the seller generally has better information about product reliability than do purchasers. Since consumers' demand for PPRs (i.e., their willingness to pay to shift the risk of product failure) will be determined by their expectations of the reliability of the product and the repair costs, if these expectations are incorrect, the combination of reliability and PPR (e.g., warranty) produced by the forces of demand and supply will not generally be efficient. For example, simple economic models 59/ show that if consumers overestimate product reliability, in the absence of other imperfections the market equilibrium will be characterized by a level of warranty protection that is below the efficient level. Consumer misperceptions will also generally lead to inefficient product reliability.

Another, similar information problem which is of particular concern for PPRs is a lack of consumer information about the PPRs themselves. The terms of the PPRs (e.g., the defects

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58/ G. J. Stigler, "Economics of Information," 69 Journal of Political Economy 213-225 (1961); A. Schwartz and L. Wilde, "Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis," 127 University of Pennsylvania Law 630 (1979)(hereinafter cited as "Schwartz and Wilde"). See also Akerlof, op cit.

59/ See, Spence, op. cit.

covered by a warranty) are often described in complex legal terms, or buried in fine print in the heart of lengthy contracts. If consumers' perceptions about what the remedy covers are incorrect -- e.g., if they expect a warranty to cover certain defects which have been excluded -- then the market will not lead to the use of optimal PPRs. More generally, whenever consumers have difficulty comparing one seller's PPR to another's, sellers' incentives to compete by offering superior PPRs will be reduced. 60/ Even if consumers would prefer to pay a little bit more for additional PPR coverage their inability to easily determine which seller offers the most coverage may prevent the market from arriving at that result.

An obvious curative for informational imperfections is the production and dissemination of information. Information can serve a market-perfecting role regarding PPRs, just as it does with regard to other product features. However, it has long been recognized that the market may produce too little information because of the difficulty involved in charging recipients of information for the benefits received. One simple example of the "free rider" problem is that Consumer Reports cannot charge all consumers who use the information provided in Consumer Reports. In addition, it has been shown that there are economic disincentives for producers to provide accurate information about product reliability. 61/ Therefore, if the government can encourage

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60/ See, Schwartz and Wilde, op. cit.

61/ Scheffman and Applebaum op. cit. If a producer sells a product for which consumers overestimate reliability, correcting this misperception will reduce the price consumers are willing to pay. However, the importance of producer goodwill may tend to counter this disincentive.

or provide information about reliability or about competing seller's PPRs, it may be possible for intervention to correct this market failure. The principles which should govern such an intervention are discussed at length in the CIR briefing book, and in further detail in the Intervention Section of this book (See Section III.B.).

b. Adverse selection

We described above how adverse selection and moral hazard may limit the scope of PPRs available in the market. Here and in the following paragraphs we consider them as market failures, and describe the actions that might reduce this effect.

Adverse selection is an information problem that limits sellers' ability to determine the riskiness of their customers. As we saw above, consumer behavior -- e.g., the extent and nature of their use of the product, or the amount of preventive maintenance they engage in -- will often be one factor in determining the likelihood of some kinds of product breakdowns. If sellers knew how much use each of their customers made (and if they could costlessly negotiate individual contracts), they could offer the light users more extensive PPRs, or charge them less for the same coverage. Without such information, though (and given the costs of individual negotiations), sellers must usually offer the same PPR to both light and heavy users, and charge them the same amount.

This is what gives rise to the problem of adverse selection. 62/ Obviously, any given PPR is more attractive to heavy users than to the light users (or more attractive to consumers who, for any reason, face larger risks), since high-risk consumers are more likely to end up using it. Thus, sellers which offer more extensive PPRs than competitors are likely to attract a disproportionate number of high-risk consumers. But this requires them to increase the costs of the PPR accordingly (to compensate for the higher risk) -- which, in turn, makes the offer even less attractive to low-risk consumers, causes fewer of them to purchase the PPR, and increases the riskiness of that seller's customer pool even further. The upshot is that there may be a large pool of low-risk consumers who would be willing to pay for a PPR which it would be profitable for sellers to offer them -- but, because of the difficulty of singling out those consumers, that PPR will never be offered. In fact, if there is enough of a range between high- and low-risk consumers, adverse selection could have the effect of denying coverage to all consumers. 63/

62/ This problem has long been recognized in the insurance literature: It is difficult to design a policy that accurately reflects the risks posed by customers when the insurer has imperfect information.

63/ This is a version of the well-known "lemons problem" described in Akerlof, *op. cit.*, and in Salop, *op. cit.*

Unfortunately, this market problem is not one that is easily corrected, as discussed previously. Unless a method is found to identify high and low risk consumers, the problem cannot be corrected at all. Further, sellers do have profit incentives to find such a method, so that if the market is unsuccessful in solving the problem, there is little reason to believe that intervention would be more successful.

It should also be noted that when a market is characterized by another market failure in addition to adverse selection, contemplated intervention must carefully consider the impact of the adverse selection problem. This is especially significant when a proposed remedy involves changing the terms of the market-determined PPR (such as changes in warranty provisions). In these cases, an adverse selection problem will raise redistributive issues which should be considered. In particular, mandating more extensive warranty terms -- with the result that sellers would raise the price of the warranty -- could penalize low risk consumers while benefiting high risk consumers. These factors may be significant when considering such a policy.

c. Moral hazard

A related problem -- also arising from the fact that both buyers and sellers can influence the likelihood of product failure -- is the problem of incentive compatability, or "moral hazard". 64/ As explained above, the problem is

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64/ See earlier discussion in Section II.A.

that, to the extent that a party will be compensated (or, in the case of the seller, will not be held liable) for product failure, that party's incentives to take steps to avoid product failure are correspondingly reduced. For instance, if all automobile problems occuring in the first 5 years of a car's life are warranted, buyers have less incentive to properly maintain and care for their car. If it is less expensive on average to care for a car rather than to repair it when it fails, this warranty policy does not provide the correct incentives for buyers.

Little is actually known about how these incentives operate. There are many reasons why consumers will maintain and care for products regardless of who bears the liability for failures. Simply the prospect of having a failure occurs, such as a car breakdown, may be enough alone to induce a high level of care, because of the time, inconvenience and loss of use of the product while repairs are made under warranty.

Refund policies can also be affected by consumer moral hazard problems. For instance, if a weight reducing/exercise spa offered a money back guaranty if a specified weight goal was not achieved, it would create less incentive for the consumer to control his diet. If effective weight control is best achieved by a combination of diet and exercise, this refund policy would not provide the correct buyer incentives. 65/

Of course, one solution to this problem would be to do away with PPRs entirely and force consumers to bear the entire cost of product failure or unsatisfactory performance. However, this would create additional, and probably even greater inefficiencies. For one thing, many consumers prefer to be insured against such risks, and (as discussed earlier) sellers are often in a position to provide such insurance efficiently. More fundamentally, sellers can also influence product performance, and shifting all the risk of product failure to consumers would simply create a new moral hazard problem on the part of sellers. Doing away with warranties or refunds would significantly reduce the incentives for automobile manufacturers to take cost-effective steps to produce more reliable and durable cars, or for health spas to design effective weight-reduction programs. The importance of seller goodwill would still provide some incentive, of course, but it will still often be efficient for sellers to be able to offer a more binding commitment.

65/ As these examples illustrate, adverse selection and moral hazard problems are closely related concepts. The general (though not universal) distinction made between the two problems is that moral hazard involves a change in consumer behavior because of a liability rule (failure to maintain properly because the product is warranted), and thus is an incentive problem; while adverse selection involves differences between consumers which are independent of the liability rule (e.g. the difference between heavy and light users or careful and careless consumers.) For a discussion of the problems of moral hazard in the context of new home warranties see J. P. Brown, "The Economics of New Home Warranties," FTC memo, (1978). For a more general discussion of the effects of moral hazard on the efficiency of various liability rules. See J.P. Brown, "Toward an Economic Theory of Liability", 2 Journal of Legal Studies, 323, (1973).

The only truly efficient solution would be to require that the actual cause of each failure be diagnosed, and compensation be awarded or denied depending on which party was responsible for the failure. However, even this solution would only be efficient in an ideal world; in the real world, such diagnosis might be either extremely costly or (in some cases) impossible. New car warranties do not cover damage from accidents, or from a failure to change the motor oil when needed. In those cases where the cost of diagnosis is low, we should expect that PPRs would be written to exclude failures arising from buyer abuse. In other cases, though, there is no unambiguous solution to the moral hazard problem -- and keep in mind that, as with adverse selection, sellers have strong profit incentives to find low-cost diagnostic methods wherever they exist. Thus, in this area too, there will usually be little economic justification for intervention to correct market failures due to moral hazard. The principal significance of this failure is that, in correcting other market defects, the Commission should be careful not to aggravate any existing moral hazard problems or to create new ones.

C. FAILURES OF EQUITY

1. Historical background

Principles of equity have long played a role in the law governing buyer-seller relations, dating back to the original establishment in England of Courts of Equity empowered to modify the occasionally harsh results reached by the Courts of Law. This role survives today in a number of specific statutory prohibitions on particular kinds of contract clauses -- e.g., state laws prohibiting garnishment of wages and creating "homestead" exemptions protecting consumers against foreclosure by creditors, laws prohibiting landlords from forcibly retaking possession during a rent dispute, and laws specifying the types of risks which must be covered in certain basic insurance policies. More generally, courts commonly rely on principles of equity in applying common law limits on the enforceability of contracts, such as the doctrines of "unconscionability" and "undue influence".

A somewhat similar role was envisioned for the Federal Trade Commission. President Wilson saw the Commission as "an instrumentality for doing justice to business where the process of the courts or the natural forces of correction outside the courts are inadequate to adjust the remedy to the wrong in a way that will meet all the equities and circumstances of the case." 66/ Judge Learned Hand espoused a similar view,

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66/ 52 Cong. Rec. 1963 (1914). See also the remarks of Senator Newlands introducing the bill establishing the Federal Trade Commission 51 Cong. Rec. at 11084 (1914).

stating of the Commission that "its duty in part at any rate, is to discover and make more explicit those unexamined standards of fair dealing which the conscience of the community may progressively develop." 67/

Unfortunately, these standards remain largely unexamined and unarticulated, and as a consequence they are often misunderstood. There is also some uncertainty concerning the relationship between these principles of equity and the goals of marketplace efficiency and consumer satisfaction which the Commission is also expected to pursue. The first part of this section will identify two principles of equity which the Commission has applied to cases involving post-purchase remedies. Succeeding parts will explore those principles in more detail, and examine their relationship with the failures of marketplace efficiency described in the preceding section.

2. Principles of equity applied to PPRs

One difficulty in discussing equity issues is that there is no well-developed "theory of equity" (analogous to the theories of allocative efficiency or welfare economics) which allows us to identify those cases where there will be a "failure of equity." Various ethical philosophers have attempted to develop such theories, of course, but these abstract philosophical theories have had little direct impact on the courts. Instead, the limitations imposed by equity on

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67/ *FTC v. Standard Education Society*, 86 F.20 692, 696 (2nd Cir. 1936), rev'd on other grounds, 302 U.S. 112 (1937). More recently, of course, the Supreme Court has also stated that the Commission may, "Like a court of equity, consider[] public values beyond simply those enshrined in the letter or encompassed in the spirit of the antitrust laws." *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 223, 244 (1972).

contractual relations have been developed slowly, on a case-by-case basis, by what the Supreme Court has called "the gradual process of judicial inclusion and exclusion." 68/ The process has been one of inductive, rather than deductive, reasoning.

However, this does not mean that discussions of equity can proceed only on an ad hoc basis. The Commission's decisions over the last fifty or sixty years -- and the even longer tradition of common law decisions which serves as background -- have carried the process of inclusion and exclusion to such an extent that the discussion can now be focused much more narrowly. Specifically, we can say that in the area of post-purchase remedies the Commission has been concerned primarily with the following equitable principles:

(1) That sellers should not be allowed to impose oppressive obligations on consumers (i.e., that consumers should not be allowed to give up "too much" in their contractual dealings), and

(2) That sellers should not be allowed to induce consumers to enter into a contract by means of oppressive techniques of persuasion (i.e., that consumers should be permitted to make their decisions in a "sufficiently rational" frame of mind).

Each of these principles, and its application to post-purchase remedies, will be discussed below.

68/ FTC v. Raladam Co., 283 U.S. 643, 648 (1931).

3. Oppressive Contract Terms

The Commission's concern for contractual provisions in which the consumer gives away "too much" finds its basis in a similar concern expressed by the courts (and, increasingly, state legislatures) in applying the common law doctrine of "unconscionability." The courts have actually been far more active in this area than has the Commission, striking down such contractual provisions as excessive liquidated damage clauses, 69/ clauses by which the consumer consents to be sued in a distant jurisdiction in the event of a breach, 70/ "add on" provisions in consumer credit contracts which allow the seller to repossess not only the purchase on which the buyer defaulted but all other unpaid purchases as well, 71/ and exclusions of a seller's liability for personal injury or other consequential damages resulting from a defective product. 72/ In each case, the provisions in question were deemed to be too one-sided in favor of the seller.

The Commission has moved somewhat more slowly in declaring contractual provisions to be unfair under this principle. Its most significant action has been the "Holder in Due Course" Rule, prohibiting consumer credit contracts which (in effect) barred consumers from raising product defects or other breaches by the

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69/ E.g., Weidemann v. Tomaselli, 81 Misc.2d 828, 365 N.Y.S. 2d 681 (1975). See also Uniform Commercial Code §2-718.

70/ E.g., Paragon Homes Inc. v. Carter, 4 U.C.C. Rep. Serv. 1144 (N.Y. Sup. Ct. 1968). See also Spiegel, Inc. v. FTC, 540 F.2d 287 (7th Cir. 1976).

71/ E.g., Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1971).

72/ E.g., Collins v. Uniroyal, Inc., 64 N.J. 260, 315 A.2d 16 (1974) seller as a defense to payment, if the contract had been discounted to a financial institution. 73/ In proposed rulemakings, the Commission has announced investigations into a variety of contract terms, such as confessions of judgments, waivers of statutory rights, and other harsh remedial clauses in consumer credit contracts; 74/ and also into disclaimers of liability and exclusions of warranty coverage in contracts for mobile homes 75/ and used cars. 76/ The Commission has also ordered automobile dealers to return to defaulting consumers any difference between the value of the repossessed automobile and the amount still owing on the sales contract. 77/

While these cases illustrate the kind of provisions which have been deemed so one-sided as to be inequitable, they do not by themselves provide a definition of "illegal one-sidedness." Put another way, while these cases establish the judicial concern

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73/ Preservation of Consumers' Claims and Defenses, 16 CFR §433 (1980). In its Statement of Basis and Purpose, the Commission announced that "[w]here one party to a transaction enjoys a substantial advantage with respect to the consumers with whom he deals, it is appropriate for the Commission to determine whether the dominant party is using an overabundance of market power, or commercial advantage, in an inequitable manner." 40 Fed. Reg. 53,524 (November 18, 1975).

74/ Notice of Proposed Rulemaking Credit Practices, 40 Fed. Reg. 16,347 (April 11, 1975). Other clauses indentified in the initial notice include wage assignments, blanket security interests, liability for attorneys' fees, and excessive late charges and extension fees.

75/ Notice of Proposed Rulemaking, Mobile Homes Sales and Service, 40 Fed. Reg. 23334 (May 29, 1975).

76/ Notice of Proposed Rulemaking, Sale of Used Motor Vehicles, 41 Fed. Reg. 1089 (November 6, 1976).

77/ Ford Motor Co., 93 FTC 402 (1979) (consent order). Although the dealers' contrary practice had not been explicitly embodied in the sales contract (so the case did not actually involve a contractual provision), the effect of the practice had been to entitle the dealer to the entire value of the automobile as a remedy for even the most trivial default.

with contracts in which consumers give up "too much," they do not tell us exactly how much is too much. In part, this is an inevitable consequence of the common law method of proceeding case by case, by a process of "judicial inclusion and exclusion." However, two additional points can be noted about these cases which will help to define the principle even further.

The first point is that, in the majority of cases, the "equitable" result was also the "efficient" result in terms of economic theory. The Commission noted this explicitly in the Holder in Due Course Statement of Basis and Purpose, which grounded the rule both in considerations of equity and in the economic principle that "only when prices approach or approximate real social costs do consumer choices in the market tend toward an optimal allocation of society's resources." 78/ Similarly, most judicial findings of unconscionability rely heavily on a showing that the consumer was either unaware of the contract clause to which he purportedly agreed, or lacked knowledge concerning the underlying risks which the clause dealt with 79/ -- either of which could suffice to prevent consumers from making an optimal decision, and make the transaction inefficient from an economic point of view.

78/ 40 Fed. Reg. at 53523 (November 18, 1975). The Holder in Due Course doctrine prevented the cost to the seller of nonperformance from approximating the social cost of nonperformance, by (in effect) insulating the seller from liability for such breaches of contract. Under the doctrine, consumers could still bring suit against the seller, but few had resources to do so. The Commission's rule remedied this by giving consumers a defense they could raise against financial institutions when sued for payment -- which thus gave those institutions a (who have the resources to bring such actions) an action over against the seller.

79/ See Fort, "Understanding Unconscionability: Defining the Principle," 9 *Loyola U.L. Rev.* 765, 782-94 (1978).

This is not meant to suggest that equity never requires a result beyond what would be required for economic efficiency. The law prohibits contracts by which consumers sell themselves into slavery (or long-term indentured servitude), even if the consumer is fully aware of the nature of the obligation and firmly believes that his or her welfare would be improved as a result. Indeed, the law often goes a good deal farther than this, prohibiting consumers from such things as assigning their future wages as security for a debt -- even though that might be the only security some consumers have to give -- or agreeing in advance not to defend against any claims a landlord may bring.

To the extent that such restrictions go beyond what efficiency requires, of course, this implies that we will be paying a price for our equity. The trade-off is usually between some more equitable state of affairs or social value (such as preserving tenant access to the judicial system) and increased costs (e.g., higher rents) to consumers who have been prohibited from assigning away their rights. 80/ The second point to note about the Commission's actions, however, is that the Commission does not make this trade-off itself. Instead, it relies on public policy as expressed by other bodies, such as Congress or state legislatures. The holder in due course doctrine had already been eliminated in a number of states before the Commission promulgated its rule; the same is true of the other contractual provisions

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80/ If the consumers in question would have preferred to pay a little more to retain those rights, of course, then the market could not have been working optimally and the remedy could have been justified on efficiency grounds.

now under investigation. 81/ In short, the Commission has used its equity jurisdiction in precisely the manner envisioned by Judge Hand, by discovering and making more explicit the standards which "the conscience of the community may progressively develop." 82/

4. Oppressive persuasive techniques

A similar analysis can be applied to the second equitable principle, that sellers should not be allowed to induce consumers to enter into a contract by means which prevent consumers from making their decisions in a "sufficiently rational" frame of mind. The principle has its roots in the common law doctrine of undue influence, which makes a transaction voidable if the dominant party exercised such persuasive force as to substitute his or her will for that of the other party to the transaction. In the words of the Restatement of Contracts, "the ultimate question is not whether the persuasion induced the transaction, for such persuasion is often permissible, but whether the result was produced on the one hand by influencing a freely exercised and competent judgment or on the other by dominating the mind or emotions." 83/

Although this doctrine was most commonly invoked in transactions between close relatives, it has occasionally been applied in commercial contexts where the subject was a highly

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81/ See notes 74-76 *supra*. This does not mean that Commission action is unnecessary, of course. Such clauses often continue to be included in contracts (and used to coerce unsuspecting consumers even after they have been declared unenforceable under state law. Given the cost of acquiring legal advice and pressing a claim in litigation, the threat of private litigation will often be insufficient to deter such conduct.

82/ *FTC v. Standard Education Society*, *supra* note 67.

83/ *Restatement of Contracts* § 497, p. 955 (1932).

emotional one and the persuasion was intense and relentless, often refusing to allow the victim to think the offer over, and purposely designed to keep the victim in a distraught state. 84/ The Commission has applied a similar principle in the context of high-pressure sales pitches. The archetypical case is Arthur Murray Studio, Inc., 85/ where a dance instruction studio was found to have recruited students by emphasizing their social or marital difficulties in order to produce a highly emotional state, maintaining the sales presentation for several hours at a time (using teams of salesmen in "relays"), refusing to allow the victim to leave the studio during the presentation or to take time to think the offer over, and insisting that a decision be made immediately. In such a state, the victim's consent could hardly be said to represent his or her own true preferences, so the Commission was found to be justified in placing a limit on the type of contracts which customers could be induced to sign. 86/

The Commission has also found similar high-pressure tactics in door-to-door sales, where many salesmen were found to use a "practiced, skilled, and almost hypnotic sales pitch which has been scientifically designed to create [in the buyer] his desire

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84/ See, e.g., Keithley v. Civil Service Board, 11 Cal. App.3d 443, 89 Cal. Rptr. 809 (1970) (resignation of a police officer who had been charged with rape); Odorizzi v. Bloomfield School Dist., 54 Cal. Rptr 533 (Cal. App. 1966) (resignation of a school teacher tendered after having been arrested for homosexual activity). The use of high-pressure persuasive techniques is also occasionally considered by the courts in voiding contracts under the unconscionability doctrine. See, e.g., Nu Dimensions Figure Salons v. Becerra, 73 Misc.2d 140, 340 N.Y.S.2d 268 (1973); Brooklyn Union Gas Co. v. Jimeniz, 82 Misc.2d 948, 371 N.Y.S.2d 289 (1975).

85/ 78 FTC 401 (1971), aff'd, 458 F.2d 622 (5th Cir. 1971).

86/ Because of the difficulty of directly prohibiting the various face-to-face selling techniques found to be unfair, the Commission rarely attempts to prohibit such techniques directly. Instead, restrictions on contracts or mandatory cooling-off periods are the usual remedies in such cases.

for something he may not need, or cannot afford." 87/ Similar techniques were found to be used by salesmen of vocational instruction courses, which played on prospective students strong desire for self-improvement and their relative lack of education and business sophistication. 88/ On the other hand, the Commission found that the "negative option plan" method of selling did not in and of itself unfairly induce consumers into purchases, even though it might occasionally play on such human traits as forgetfulness or procrastination. 89/

As in the area of oppressive contractual provisions, the cases dealing with oppressive persuasive techniques do not do much more than identifying specific techniques which have been found to violate this notion of equity. They illustrate the gradual judicial process of inclusion and exclusion, but they do not (as of yet) define a minimum level of rational deliberation which consumers should not be forced below, or tell us how to determine which groups of consumers are particularly vulnerable

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86/ Statement of Basis and Purpose, Cooling-Off Period for Door-to-Door Sales, 37 Fed. Reg. 22934, 22938 (October 26, 1972)(footnotes ommitted).

87/ Statement of Basis and Purpose, Proprietary Vocational and Home Study Schools, 43 Fed. Reg. 60796, 60800 (December 28, 1978). Under common law, the weakness or susceptibility to persuasion of the dominated party was an important factor in applying the doctrine of undue influence. See Restatement of Contracts §497, supra note 18. The Commission's initial notices of proposed rulemaking for funerals (40 Fed. Reg. 39901 (August 29, 1975)) and Hearing Aids (40 Fed. Reg. 26646)) announced investigations of the extent to which customers of those services were vulnerable to exploitation by similar high-pressure selling techniques.

88/ Statement of Basis and Purpose, Use of Negative Option Plans by Sellers in Commerce, 38 Fed. Reg. 4896 (February 22, 1973).

to which kinds of persuasive techniques. While the cases establish the equitable principle that consumers should be allowed to make their decisions in a "sufficiently rational" frame of mind, they do not tell us exactly how much rationality is "sufficient."

A somewhat better idea of the scope of the principle can be had, however, by comparing it with the analogous principles of economic efficiency. Again, it can be noted that most of the Commission's decisions could be supported just as well on the basis of efficiency, for (as in the cases dealing with oppressive contract clauses) the equitable result has usually been the efficient one. Economic efficiency in a free market depends on allowing consumers to pursue their own preferences. This principle is obviously violated if sellers are allowed to divert consumers from their true preferences by means of fraud; most would agree that it is also violated if sellers are allowed to induce consumers to purchase by hypnotizing them, by drugging them, or by acting on their subconscious by means of subliminal conditioning. 89/ At some point, it it true, the line between subverting a buyer's "true" preferences and merely responding to those preferences becomes an extremely fuzzy one, and one which is impossible to draw on the basis of a pure efficiency analysis. However, analyzing the problem on a different level, it can be observed that many consumers would (if asked in advance) prefer to insulate themselves from certain persuasive techniques and

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89/ Subliminal adverting -- the practice of flashing advertisements on the screen too quickly to be consciously perceived -- has been prohibited by the FCC. See Broadcast of Information By Means of "Subliminal Perception" Techniques, 44 FCC 2d 1016 (1974).

(if asked after the fact) regret having been exposed to them. If large number of consumers hold such preferences, but are still unable to resist the persuasive techniques when exposed to them in any given instance, then the fact that such techniques will continue to be used in spite of consumers' "calmer" or "more deliberate" preferences can in some sense be characterized as a market failure.

Of course, whenever we prohibit such techniques (or require those who use them to provide a PPR such as a cooling-off period), we also impose costs on the market. Some consumers may like being persuaded by fast-talking door-to-door salesmen; others (more realistically) may consider themselves able to resist such blandishments and prefer not to pay the added expense imposed by mandating a PPR for all consumers. If those costs are sufficiently high to make sales to some classes of consumers unprofitable, then those consumers could (in effect) be denied access to a particular method of marketing. This could make the price for our pursuit of equity may well be higher than we wish to pay. The point to note, however, is that in making this judgment as well the Commission has consistently relied on declarations of public policy expressed by other bodies. Cooling-off legislation had been adopted by thirty-three states, and reported on favorably by a number of public bodies, before the Commission promulgated its rule. 90/ The problems with the

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90/ Statement of Basis and Purpose, supra note 86, 37 Fed. Reg. at 22935 (October 26, 1972). Many cities had banned door-to-door selling completely; see Breard v. Alexandria, 341 U.S. 622 (1951). The problems often connected with face-to-face selling techniques were subsequently recognized by the Supreme Court in Ohralik v. Ohio State Bar Ass'n, 98 S. Ct. 1912, 1919 (1978)(attorneys' in-person solicitation of clients not projected by First Amendment).

high-pressure sales techniques used by many vocational schools had been recognized both by state consumer protection agencies and by federal agencies such as the Veteran's Adminstration and the U.S. Office of Education. 91/ Thus, in applying this principle too, the Commission's actions have been limited to carrying out its duty to apply the "standards of fair dealing" which society has progressively developed.

5. Conclusion

In the area of post-purchase remedies, the Commission has taken action to prevent two sorts of failures of equity: sellers' insistence on oppressive contract terms, and sellers' use of unfair techniques of persuasion. In the vast majority of cases, the Commission's actions were also consistent with the goal of allocative efficiency and economic welfare, and could have been supported on that ground as well. The Commission has always been sensitive to the fact that pursuing equitable principles beyond that point could lead to a reduction in allocative efficiency, and that this reduction would constitute a real price to be paid for its pursuit of equity.

However, society (through its governmental institutions) has occasionally been willing to insist on principles of equitable dealing even when this might result in some sacrifice of allocative

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91/ Statement of Basis and Purpose, *supra* note 87, 43 Fed. Reg. at 60802 (December 28, 1978).

efficiency. The Commission therefore has not limited its pursuit of equity to those principles which are demonstrably consistent with economic theory. In applying equitable principles, though, the Commission has been properly reluctant to strike its own balance between equity and efficiency. Consequently, it has acted on this theory only when that balance has been settled by the standards of society, as reflected in some established public policy.

III. INTERVENTION

A. GENERAL PRINCIPLES OF INTERVENTION

The previous section identified the kinds of "market failures" which might prevent the market from reaching the most equitable or most efficient combination of product quality and PPR coverage. This section considers the various intervention strategies available to the Commission to correct (where possible) the marketplace deficiencies. 92/

In evaluating any intervention, the ultimate question is whether its benefits outweigh its costs. This is an especially important issue where (as here) the costs are ultimately passed back to consumers in the form of higher prices or reduced product quality. An exact assessment of benefits and costs cannot be conducted in the abstract, of course; precise measurements will often be difficult even in the context of specific intervention proposals. However, the succeeding sections -- which discuss each of the various intervention strategies -- will indicate the kinds of benefits and costs which ought to be taken into account whenever any specific proposal is being considered.

The task of designing a cost-effective intervention will be easier, however, if certain general principles are kept in mind. While these principles will not automatically lead to the best intervention strategy, they do serve as "rules of thumb" for maximizing the benefits and minimizing the costs.

92/ We refer to these as "interventions" rather than "remedies" to distinguish them more easily from post-purchase remedies in general.

Thus, in selecting the best intervention strategy, it is useful to consider (1) the intervention's relationship to the market failure, (2) its restrictiveness and compatibility with market incentives, and (3) in the case of information interventions, its communication effectiveness.

1. Relationship to the market failure

The starting point for any intervention strategy is the identification and analysis of the market failure responsible for the problem. Without understanding the forces which produced the problem in the first place, it will be difficult to ensure that the problem will actually be solved, or that the same forces will not break out in some other form (possibly causing an even greater problem). For example, requiring a seller to offer a higher level of PPR coverage will probably not be an effective solution if the reason why the market did not force the higher level of coverage is that the seller was a monopolist. The seller will have every incentive to avoid performing his obligations under the higher coverage, thus keeping the *de facto* level of coverage the same as it always was. And even if this loophole is closed off by the FTC (by incurring significant monitoring and enforcement costs), the fact that the seller still has the power to respond by charging a higher monopolistic price may prevent consumers from gaining any real benefit from the intervention. The only real remedy for this problem would be a remedy which got at the root of the problem by somehow eliminating the seller's monopoly power.

More generally, identification of the market failure will usually suggest the most effective method of curing the problem. If the problem is caused by the cost to consumers of informing themselves about product performance or about the PPRs offered by a seller, then actions designed to disseminate that information (or reducing consumers' information costs) are likely to be the most effective. If the market failure is one of high enforcement costs which prevent consumers from holding sellers to their PPRs, then actions which would reduce enforcement costs should be considered.

Of course, as the previous chapter noted, not every problem can be corrected through intervention. It is simply not cost-effective to eliminate all risk of product failure and, as a result, the remaining risk must be allocated somehow. The market's allocation of risk will not be perfect, but if it is imperfect because of problems of adverse selection or moral hazard, there may be no way to efficiently improve on that allocation. Requiring sellers to offer broader PPR protection will simply aggravate those problems, benefitting the high-risk buyers at the expense of raising the price to low-risk buyers (possibly pricing them out of the market). 93/ In the case of moral hazard problems, mandating greater PPR coverage will reduce the incentives for buyers to take their

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93/ If there is some way of separating the high-risk from low-risk buyers, this problem can be corrected, so this is where the search for an intervention strategy should focus. As the Overview section noted though, the market will usually already be making this separation whenever it is cost-effective to do so. For example, insurance applications require detailed information in order to sort buyers by risk, and automobile warranty protection usually varies with the automobile's mileage.

own cost-effective steps to reduce the risk of product failure, leading to a higher incidence of failure, and increased costs to be passed on to all buyers. Broader PPR coverage may still be desired for equitable reasons, but only at the expense of compromising the risk reduction incentives and forcing low-risk buyers to subsidize high-risk ones.

2. Restrictiveness and incentive compatibility

Any intervention will restrict the market outcome, and thus will be at least somewhat incompatible with market incentives. However, as a general rule, Commission actions will tend to be most effective if they replace market incentives no more than is actually necessary to effect the desired outcome. The extent to which the action makes use of market incentives is referred to here as "incentive compatibility".

This principle is best understood by considering a spectrum of possible actions to improve product performance. The most restrictive intervention would one which required sellers to build the product in a specified way, which would result in a better product. 94/ A slightly less restrictive intervention would require the finished product to meet specified performance standards, relying on sellers' normal market incentives to lead them to choose the most efficient method of meeting those standards. A less restrictive intervention still would be to force the seller to bear the cost of any product failure, thus leaving it up to the seller to

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94/ Remedies at this end of the spectrum are usually referred to as "command and control" regulations. Government standards for automobile safety and emissions are like this--they specify design and performance standards for things like seat belts, tailpipe emissions, etc. Health and safety standards in general take this form.

decide what level of performance standard would minimize total costs (as well as how that performance standard could be most efficiently achieved). An even less restrictive Commission action would be to provide consumers with information about the likelihood of product failure and the extent of PPR protection offered by each seller, thus leaving it to consumers to select the amount of liability they are willing to pay sellers to assume and the amount that they would prefer to assume themselves.

The advantages of intervention strategies toward the less-restrictive end of the spectrum are twofold. First, they tend to be easier to enforce. They usually require less monitoring of day to day behavior, and the fact that they largely rely on marketplace incentives means that that aspect of the remedy need not be enforced at all. Second, and even more importantly, less restrictive interventions are (almost by definition) more flexible and less likely to produce undesirable side-effects. An attempt to specify a specific level of PPR coverage or product performance, for example, runs the risk of setting a level that is higher than consumers are willing to pay for; it also must be continually adjusted (or risk consumer injury) as changes in technology or in consumer preferences make some other level more appropriate. By contrast, simply providing consumers with information about the level of PPR coverage or product performance should insure that the level actually selected is the one that most consumers prefer, without locking the market into that level

best copy available

if consumer preferences should change. In short, increasing the flexibility of an intervention (or reducing its restrictiveness) is an extremely effective method of minimizing any unintended costs.

Of course, the Commission action must still go far enough to insure that sellers are given the proper incentives. The purpose is to work a change in the normal market incentives (i.e., to correct a market failure), and anything which stops short of that point will be useless. For example, it does little good to provide buyers with the information needed to select the optimal PPR if enforcement costs (and a lack of concern for customer goodwill) have freed sellers from most incentives to perform their obligations. In these cases, intervention might have to also focus on the enforcement of PPRs, either by providing less-costly methods for consumers to enforce their claims (i.e., dispute resolution systems), or by providing consumers with data on different firms' track records in performing their post-purchase obligations. More restrictive interventions might also be required if information is prohibitively expensive because of the costs of effectively communicating the information to consumers. The point here is simply that the inquiry should begin with the less restrictive actions because of their smaller enforcement burdens and lower likelihood of unintended side-effects. The inquiry should move to the more restrictive interventions where the less restrictive ones are too costly to implement or where they would not be effective.

3. Communication effectiveness

A final principle to be considered in connection with information remedies, is that the information must be effectively communicated if the remedy is to be successful. Communication is more than just a matter of making undigested information available to consumers; it must usually be summarized, put into a form they can easily use, and communicated in a way which gets it to them when they are ready to use it. 95/ If the information which the market needs cannot be communicated effectively (or at a feasible cost), it may be that some non-information remedy should be adopted instead, or (if this would also be too costly) that the problem is simply beyond the reach of any effective intervention.

Communication effectiveness is also an important characteristic of marketplace PPRs, for the same reasons. Consumers can only express their preferences for greater (or lower) PPR protection if they are aware of the PPR provisions offered by various sellers. If consumers are unaware of or cannot readily understand material clauses in the PPR, there will be no reward for sellers who offer better PPRs, and the market will not lead to the optimal result. Thus, in addition to making sure that all information remedies communicate effectively, communication effectiveness should also be encouraged in PPRs themselves.

95/ This principle is discussed extensively in the CIR briefing book.

4. Applying general principles to Commission interventions

In the following sections we consider, in turn, the range of possible Commission interventions regarding PFRs: information, enforcing existing PPR performance, and mandating PPrs. In each of these categories there are a number of types or variants, which are described in the above Catalog (Section I). We have included in our analysis here most, but not all, of these interventions, omitting those which are rarely used or are an unimportant part of the Commission's actions.

In each section we review the strategies; consider where they might best be applied; discuss their effect on buyer and seller incentives; and assess the advantages and disadvantages of the particular intervention. In discussing enforcement of PPRs, we have included an extensive review of the informal dispute resolution mechanisms which have developed in the market absent any legal mandate. While this discussion might have been placed in the Overview description of marketplace PPRs (Section I.A.), we placed it here because it is an area in which the Commission is in a position to have considerable influence, and because the discussion fits well with the discussion of Commission-mandated dispute resolution that follows.

A summary of the advantages and disadvantages of each suggested intervention is found in Appendix A.

B. INFORMATIONAL INTERVENTIONS

Among the three classes of interventions, a strategy of encouraging or requiring the disclosure of information to buyers is generally the lest restrictive alternative. As discussed earlier in this book and in the CIR book, informed decision making by even a minority of consumers can bring about an efficient outcome in the marketplace, barring traditional antitrust problems. As sellers compete for the patronage of informed buyers by offering superior products or PPRs, even uninformed buyers benefit.

As outlined in the Overview Section, consumers may have inadequate information about a number of important attributes of a transaction. These informational imperfections may arise either from a shortage of essential information, deceptive claims, or sales practices that reduce buyers perceived need to gather further information. Information shortages may be placed in one of the following three classes: (1) information about product or service performance, (2) information about PPRs offered, and (3) information about sellers' performance under PPRs. In order to aid consumers in making more informed purchase decisions, an intervention strategy that aids the collection and dissemination of information in a effective manner may be called for. We now take these up in turn. Because many of these issues have been discussed in detail in the CIR, the analysis here is presented only briefly, and it focuses on a number of issues most relevant to PPR information.

1. Information about product or service performance

Various measures of durability and reliability may be useful to consumers in choosing a product or service. For examples, in order to determine which of several appliances represents the best value, it would be useful to know, in addition to the usual price and features information, the expected life, frequency of repair, cost of repair, and other risk information. For a service like a vocational school, the dropout and failure rates for the course of study and the likelihood of obtaining a job and associated income are relevant attributes.

Except perhaps in the case of newly offered products or services, sellers have far better information about these attributes than individual buyers. Data regarding product experience may be impossible for an individual buyer to collect. Therefore, efficiency would generally dictate a responsibility of sellers to disclose such information or to disclose data for an outside group to analyze and summarize the experience. However, there are a number of limitations to the efficiency of such a responsibility that must be taken up.

First, for some products, buyers may differ substantially with respect to either information needs or the ultimate balancing of considerations in evaluating products on the basis of that information. For example, a backyard mechanic might be concerned with the cost of parts and the ease of repair in the event of product failure, whereas someone who depends on an automobile for business may be more concerned with the frequency of even minor breakdowns. Similarly, someone who keeps products for a long time will have different informational needs than someone who frequently replaces them with a new model before the old one has had much use. As a result, it may be difficult to tailor the information to the needs of any particular buyer or to buyers in general.

Second, as discussed in the sections on moral hazard and adverse selection, the actual product failure rate experienced may depend significantly on the buyer's failure prevention activities and use of the product. For example, appliance breakdowns tend to depend more on the rate of use than simply the age of the product. In this case, since different consumers can expect different failure rates according to their particular use patterns, disclosure of an average failure rate or average annual cost of repair may not be very useful to any consumer. Instead, instructions for maintenance and other failure prevention actions may be more significant pieces of information.

These considerations might be less relevant if buyers could easily process large quantities of information in an effective manner. If so, a seller might disclose all the relevant attributes of product performance and make available detailed instructions for care and maintenance. However, as discussed in detail in the CIR, presenting too much information may result in too little information being effectively used. As a result, it is generally necessary to compromise information completeness in order to achieve effectiveness of communication.

This compromise has been struck in a variety of ways in past Commission actions. In the appliance labeling rule, an energy efficiency rating was devised to communicate most effectively. In the proposed "piston scuffing" consent order, technical service bulletins with information about defects are to be disseminated by Ford. 96/ The proposed used car rule disclosure summarizes quality information in 14 areas of mechanical condition. Consumers Reports disseminates statistical data regarding frequency of repair of different car models. No single strategy is the best for all products and in all situations. As such, in any particular case, the diversity of consumer needs and characteristics of the product must be carefully considered in order to discover the best mix of completeness and communication effectiveness.

2. Information about PPRs

Buyers' information about the scope and degree of coverage of the PPR may be limited or incorrect. This might occur if the PPR is unavailable before purchase or if the written description of the PPR terms is in incomprehensible language or is deceptive. For example, a warranty may clearly place liability for defects on the seller, but another clause may condition this on the consumer bearing the cost of shipping the product to the factory. If the product is a piano -- in fact, this clause is commonly called a "Baldwin piano clause" -- the warranty will have little value to the buyer. Yet the buyer may be unaware of the limitation or underestimate the shipping costs.

96/ Ford Motor Co., Docket No. 9105, (provisionally accepted order 45 Fed. Reg. 13115 (February 28, 1980). The sample bulletin reproduced in Appendix D was designed to make this type of technical information accessible to consumers.

Information is needed both at the time of purchase and at the time of product breakdown. At the point of purchase, the consumer utilizes information about the PPR to select the best product, both in terms of expected product performance and liability (risk-sharing) in the event of product failure. At the point of breakdown, the consumer needs to know the procedures for obtaining service and perhaps more detailed understanding of the exact scope of the PRR. These different needs complicate what might otherwise be a simple communication problem. As discussed previously, it may be necessary to strike a balance between completeness and communication effectiveness.

In this regard, one approach might be to disclose a summary statement of the PPR at the time of purchase. In this way, certain less significant details of the PPR could be ignored, until they become relevant at the point of breakdown, in order to avoid information overload and increase consumers' comprehension of the most significant PPR terms.

This is the basic approach taken in the Magnuson-Moss Warranty Act and associated efforts to make warranties more readable. By defining the required terms for "full" and "limited" warranties, statute enables the consumer to use these summary measures of warranty scope and coverage, rather than being required to evaluate a number of complex legal provisions for different products.

In the context of particular products, this approach may be further developed. Sellers might summarize the sense of the PPR, perhaps according to a standard form and standard categories, without disclosing exact performance in every contingency. If such summaries are presented non-deceptively, they can aid consumers in making product choices. At the same time, the more detailed statement of the PPR could accompany the summary statement, for use by more interested or sophisticated potential buyers at the time of purchase, and detailing the exact provisions for performance of the PPR for use by buyers at the time of product failure. This general approach has been used with complex insurance policies. It may have further application in the consumer market.

For some cases, it may be more cost-effective to prohibit PPR provisions that are misperceived rather than bear the cost of correcting the misinformation through an information intervention. Returning to the example of the "Baldwin piano clause" in warranties, if the shipping expense always exceeds the cost of self-repair, then such a provision makes the warranty worthless to all consumers: the offending clause can then be prohibited at no loss in efficiency or equity. In this extreme case, an information intervention would focus on inducing all consumers to unequivocably ignore the warranty promise. Rather than design an information remedy that will succeed in 100 per cent of the cases, it would be more effective to simply ban the clause. In less extreme circumstances, however, where the PPR is not always worthless to all consumers, an informational intervention might be more appropriate. This is the approach taken under Magnuson-Moss;

deceptive clauses are prohibited, but clauses which limit the value of warranty coverage must simply be disclosed effectively. 97/

3. Information about sellers' performance under PPR

A PPR is only a valuable product attribute if sellers perform their obligations in the event of product failure. As discussed previously, sellers may fail to perform adquately if consumers have limited recourse to enforcing the PPRs through the legal system, and if consumers are poorly informed in advance about the poor performance.

Pre-purchase information about a seller's performance of PPRs can perfect market forces and improve competition. Consider the market for warranties. A warranty's value to the buyer is enhanced or reduced (relative to competitors' warranties) by the degree to which the warrantor can be predicted to deliver on the warranty promise. For example, two competing firms offering identical warranties and having identical product quality may make widely different investments in carrying out those assumed liabilities. One firm may provide repairs of all defects promptly, rarely lack needed parts, and have servicers that accurately diagnose and repair problems. The other firm may invest little in performance, leaving customers with products with reduced utility and with additional costs from the defect. An adequately informed buyer can factor this into the purchase decision; a buyer without this information may suffer

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97/ Deceptive warranty terms are defined and prohibited under 15 USC §2310(b); terms that limit coverage or remedies must be disclosed under 15 USC 2302(a) and 16 CFR 701 (1980).

unanticipated costs from the bargain. The market-perfecting function of information may result in performance at better levels than at present.

Information provides incentives for sellers to improve performance to gain the patronage of consumers who value good performance. Buyers who wish to reduce the risk and costs of unfulfilled PPR promises need only seek out the firms with the best record. However, sellers must keep prices competitive, and so they can improve performance only in ways that are efficient.

However, it has not yet been demonstrated that ratings can improve or lead consumers to shift demand to firms with good ratings. 98/ Indeed, there are a number of issues which need to be resolved before this approach is selected. The first is to identify the markets where the information is likely to be valued and used by consumers, and where consumers' responses will affect prices or performance. The major consumer durables markets where warranty performance complaints are high and individual losses are substantial -- motor vehicles, appliances, and new homes -- are the most likely candidates based on casual observation.

Second, a methodology for rating warranty service must be developed. This can be done by first determining what aspects are valued by consumers, and assigning weights or values to them -- that is, the weight to be given to speed of services, or to the need for repeat service, or measures

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98/ This suggests an area for initial inquiry: to study the impact of currently published ratings of products (e.g., Consumer Reports) and services (e.g., Washington Checkbook).

of customer satisfaction, and so on. A balance must be struck between complete information and effective communication. Then a survey methodology and rating scheme must be designed and tested. Several follow-up surveys are needed to demonstrate how firms with low ratings respond to market pressure once the initial survey results are published. The shifts here will be the proof of whether and how much the market values the additional information, and will answer the question of the benefits of the information.

Finally, and crucial for the FTC, the project must be one that can be designed to be passed along to other groups -- state agencies, local consumer groups, etc. -- that will use the proven methodology to repeat the surveys.

Ratings of performance of services may be costly to compile and difficult to communicate. However, the potential for this kind of rating service has been demonstrated in Washington, D.C. by Washington Checkbook, which rates local services. Another group's preliminary study has demonstrated that wide variation in warranty performance can be observed among auto manufacturers and among auto dealers. 99/ Even the auto dealers have shown that they give the manufacturers widely varying grades on warranty administration. 100/

99/ K. McNeil, R. Miller, "The Profitability of Consumer Protection: Warranty Policy in the Auto Industry," (unpublished) (November, 1979).

100/ National Automobile Dealers Assn., 1976 Dealer Warranty Survey.

4. Advantages and disadvantages

Information about product or service risks and about the seller's PPR offerings remedy market failures characterized by a shortage of this type of information. An intervention to increase the amount of information available to consumers is not considered intrusive because the market still determines the level of PPRs that will be offered. Because these two types of information are necessary for the consumer's assessment of the value of PPRs, it is important that information be adequate on both counts. Information on PPR performance can resolve indirectly the problem of high enforcement costs.

Some disadvantages are that for many situations, the information may be very costly to collect and effectively communicate to buyers. This is less likely for information about the PPRs offered by sellers, since this must already be in the contracts. But information on risks and on PPR performance are likely to be complex and difficult to summarize in a form that is helpful to buyers.

C. ENFORCING PPR PERFORMANCE

1. Introduction

In this section we consider the intervention strategies for the Commission to enforce PPRs. There are cost-effective and efficiency-enhancing ways for the Commission to supplement the market and the legal system to enforce contracts. This can be done indirectly with information; by making PPR performance terms specific; by simplifying and otherwise reducing the cost of private enforcement; or by direct Commission enforcement measures.

An unstated assumption of the discussion of the economics of PPRs in the Overview Section is that contracts will be performed; if this is not done privately, the power of the state, through the courts and the common law, is available for enforcement. Moreover, a properly functioning market rests on the commonly held belief that the law will enforce contracts. Besides fulfilling general social ideals of justice and preserving faith in the marketplace, the law serves here to help perfect the market. It does this by compensating those who are injured along the way in the market process -- an important equity consideration -- and in doing so it accelerates the process itself. A firm that follows a strategy of depleting its goodwill by reneging on its contracts and refusing to perform its warranties will deplete its goodwill over time; legal judgments and penalties for that decision will increase the speed of this process.

The Overview Section 101/ described how the market responds to risk by providing contracts that tend towards the most efficient reduction of risk. If consumers are adequately informed, markets also tend towards efficient levels of contract performance. As contracts provide incentives to reduce risk, they may also provide incentives for full performance of the assumed liabilities. A contract promising "satisfaction guaranteed or double your money back" sets a penalty to ensure seller performance. The market can also provide its own enforcement mechanisms: 1) the seller's need to retain goodwill by fully performing its contracts; 2) contracts that precommit the seller to arbitration or other informal dispute resolution; if these fail, buyers have ultimate recourse to the courts to compel performance.

Market failures may inhibit the operation of these market solutions to the risk of non-performance; failures may be caused by either an uncompetitive market structure, or by a lack of adequate information (such as that evidenced by sellers' lack of concern with goodwill). These market imperfections are further complicated by the lack of an effective and economically feasible means of securing enforcement of small contracts through the courts.

This section describes several Commission strategies (but not all) for addressing these market failures. We

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101/ See Section II.A.

discuss them here in the order they appear in the Catalog of Commission PPRs 102/:

1) Information about firms' PPR performance records,
2) Promoting private enforcement by making contracts explicit,
3) Promoting private enforcement by voluntary or mandatory dispute resolution procedures. 103/

In discussing each of these strategies we will take note of the incentives for risk reduction they provide for sellers and consumers. Our summary lists the advantages and disadvantages of each of the suggested strategies. First we consider the market mechanisms for enforcing contracts and the role of civil courts, and their limitations.

2. Potential market failures affecting PPR performance

In those markets where PPR non-performance causes substantial injury, we observe a high rate of consumer complaints, such as the complaints about automobile warranty performance that consistently top the FTC's mailbag list. 104/

102/ Section I.A.

103/ Another type of direct enforcement noted in the Catalog but not discussed here is redress. We leave that subject to a more detailed discussion at a later date. Direct FTC enforcement through orders to repair or replace defective products is discussed in the following Section on Required PPRs, Section III.E.

104/ Memo to Commission, "Digest of Consumer Complaint Correspondence," 1st Quarter, FY '80", Carol M. Thomas, January 24, 1980. Complaints about automobiles and auto parts/services together were nearly 20% of all letters; most of these concern new car warranty performance.

Understanding why firms can have high complaint rates yet not suffer debilitating losses in goodwill or in legal judgments is crucial to evaluating the potential source of market failure here.

The discussion of market failures in the Overview 105/ describes how markets with no strong brand identity and low repeat sales do not permit goodwill to serve as a marketplace check on firms' PPR performance. Fly-by-night sellers, certain mail order firms that concentrate on high turnover of new customers 106/, and firms that sell only a single product bought only once in a very long time (investment land, mobile homes, new homes, etc.) have reduced market incentives to invest in goodwill. It is not surprising, then, to observe complaints about PPR performance in these markets. 107/ Indeed, they are among the markets where the FTC has so far concentrated its efforts for PPR performance.

But we occasionally observe high rates of warranty complaints in industries where repeat sales and brand identity are very important, such as new cars and appliances. Here the firms may be operating in a market environment that permits considerable goodwill losses without hurting their competitive standing, and a legal environment that shields them from much of their potential liability.

105/ See Section II.B.

106/ Firms can use high advertising volume, a number of corporate names, and low-priced products to avoid loss of goodwill. Non-performance by mail-order firms is a common complaint. Market Development Corp. et al., 3 CCH-TRR ¶21,651 Docket No. 9067 (January 15, 1980); Samuel E. Womack, 92 FTC (1978).

107/ Las Animas Ranch, Inc., 89 FTC 255 (1977); Australian Land Title, Ltd., 92 FTC 362 (1978); Fleetwood Enterprise, 85 FTC 414 (1975); Kaufman & Broad, 93 FTC 235 (1979).

Goodwill may be limited as a market force to enforce PPRs in the following situation. A firm (say an automobile or appliance manufacturer) presented with an expensive and apparently justified warranty claim will weigh the costs of paying the claim against the loss to goodwill from not paying. The seller may decide to suffer the goodwill loss, particularly where the marketing costs to make a sale to a new customer (called a "conquest" when a competitor's customer switches over) are less. This may account for why some firms seem to do a fairly good job of performing warranty repairs for minor problems, but balk at major repairs and at requests to replace "lemons." Large injuries, of course, invite legal actions by consumers.

The injury to consumers from a breach in PPR performance is direct and immediate. They lose not only the premium paid for the PPR protection, but also a loss in the value of the bargain, and in the case of consumer goods, the costs of repairs, temporary substitute goods (e.g., a rental car) and sometimes considerable consequential damages. The question then is, how large a loss will consumers find to be acceptable risks before pursuing contract enforcement through the legal system?

Very large losses, is the apparent answer, and the reasons lie largely in the economics of the market for legal services. The high costs of lawyers' services, the costs and time for court procedures and the uncertainty of outcome all make lawsuits impractical for the consumer with a typical warranty or other PPR claim. A study of Wisconsin lawyers shows that they are generally unreceptive to client's requests to bring breach of warranty suits, even suits for thousands of dollars, because they believe they are not economical for their clients, are difficult to try, and do not generate high enough fees. 108/ This is true even where the Magnuson-Moss Warranty Act provides for possible recovery of costs and attorney fees on the basis of time expended. 109/ The restrictions on the class action as a procedure for consumers claims -- once hearalded as a savior for consumer contract claims -- are well known.

Given these limitations of the market and legal enforcement of contracts, there are a number of interventions the FTC may consider. We take up several of these in the following discussion.

3. Information on PPR Performance

We have already discussed above one intervention strategy regarding PPR performance -- information. 110/ This may take the form of warranty performance ratings. The problems associated with this information strategy, and its advantages and disadvantages, are noted in the above discussion, and so we do not repeat them here. Information of this sort may be a useful complement to one of the other interventions discussed herein.

108/ S. Macaulay, "Lawyers and Consumer Protection Laws: An Empirical Study," (unpublished)(1979).

109/ 15 U.S.C. §2310(d)(1). The Macaulay study found that few attorneys knew of the fee recovery provision, but that once informed of it they did not generally change their views.

110/ See Section III.B.

4. Setting explicit PPR performance standards in contracts

Where the problem of non-performance is persistent or widespread, where the damages are great (particularly unrecoverable and unavoidable incidental and consequential damages), and the product is a necessity, more intrusive remedies may be justified.

Where the market failure leading to poor PPR performance can be traced to the high costs of private enforcement, any intervention that reduces the possibility of disputes or the cost of resolving them can be helpful. One such intervention is to require that contract PPR terms be specific regarding what performance is called for by the seller. Specific and explicit terms help buyers and sellers resolve what performance is called for, and, where resort must be had to a court, the contract simplifies the court's task of interpreting the performance standards.

We are concerned here principally with the warranty terms for consumer products and the performance they call for. Typically the warranty calls for repair, replacement or refund, but does not specify when this will be done. Often warranties call for repairs only, and may specify repairs as the exclusive remedy, but do not specify what the seller will do if repairs are not or cannot be made. These issues -- time for repair and extraordinary remedies -- often underlie warranty performance disputes.

These issues are now resolved through informal negotiation or by courts. For those few cases that can be brought to trial, the court has the guidance of the UCC to determine these sorts of issues. Where the contract is silent, the court may find what is a "reasonable" time for performance. [111] For remedies that fail, such as repeated unsuccessful repairs, the UCC grants the buyer other remedies: damages, replacement, or refund. [112]

If contracts were explicit on these points, the task of enforcement for the buyer would be greatly simplified. There would be considerably less room for disagreement over the standards for prompt performance and satisfactory remedies. For the Commission, the critical decision are to identify the kinds of contracts that can benefit from more explicit terms and, where appropriate at what levels to set those terms.

Two examples from past FTC rules illustrate the Commission's options. The first is the Negative Option rule provision setting 10 days as the minimum time for an enrollee in a purchase plan to reject a selection (typically, these are book and record clubs). The contract may not set the time any shorter. This contrasts to the Mail Order rule's 30 days to deliver provision; here the 30 days can be extended with the buyer's explicit agreement either at the time of sale, or at the 30 day point when the buyer is given an option of a refund or delayed delivery. A third variant--and one not yet used by the Commission -- would be to require the contract to set any period for performance, but require that it be explicit and unambiguous. Thus a warranty would be required to specify "..will be repaired within ____ (number) days."

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[111] UCC §-204.

[112] UCC 2-719(2), 2-711, 2-714. See also UCC 2-608.

The Commission should consider setting the standard when the common law precedents are clear on what is a reasonable performance standard. A fixed standard adds certainty to the transaction; however, it may lead to inefficient results where it would require performance at a level for which some buyers would not be willing to pay. Any such effects can be minimized by setting the standard at an outside limit -- that is, at a level that would call for improved performance for only the most egregious failures. The price for this improvement is one consumers can be presumed to wish to pay.

The alternative is to permit the buyer and seller to set the standard or alter the Commission standard by explicit agreement. By requiring that the change in the standard be done especially conspicuously or, as in the Mail Order rule, by a separate agreement, it can be assured that the buyer agrees to the change.

Where information is not a practical remedy, and where performance standards cannot be set prospectively because the facts in cases vary greatly, the Commission can pursue other strategies that reduce the costs of enforcing contracts. One such strategy is to help provide informal mechanisms for resolving disputes: mechanisms that do not present the considerable barriers of the civil courts, but which can consider the facts in each case. We turn here to an extensive consideration of consumer dispute resolution mechanisms ("CDRMs"); the length of the discussion is an indication of our view of their importance and their potential promise for improving PPR performance.

5. Encouraging market development of CDRMs

a. Market impetus for informal dispute resolution

The consumer with a post-purchase problem has a variety of courses of action available to him. Most direct, and most frequently used as a first step, is to communicate the problem to the seller and seek a quick resolution. 113/ Failing to reach a satisfactory resolution, the buyer may turn to the manufacturer (if the manufacturer is not the seller), seek third-party help, or abandon the attempt altogether. Third party complaint handling may be quite informal -- a telephone call or letter to a newspaper or television "Action Line" reporter -- or it may involve formal litigation and recourse to the judicial system. Dissatisfaction with the expense and lengthiness of judicial proceedings provides the impetus for the development of less costly and less cumbersome procedures for handling consumer disputes in a fair and expeditious manner. Such procedures, known as consumer dispute resolution mechanisms (CDRMs), are the focus of this discussion.

Access to a CDRM serves to assure the consumer that he has the option of presenting his dispute to a forum that is, in principle, impartial and relatively easy to use. This, in turn, can enhance the buyer's perception of the desirability of the seller's product by reducing the risk that the buyer

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113/ The majority of complaints in most consumer goods industries are resolved to the buyer's satisfaction in one or two attempts, though there is significant variation across industries. For comprehensive analysis, see "Warranties Rules Consumer Baseline Study Final Report", Arthur Young and Co. (1979), and A. Best and A.R. Adreasen, "Consumer Response to Unsatisfactory Purchases: A Survey of Perceiving Defects, Voicing Complaints, and Obtaining Redress," Law and Society Review (Spring 1977).

will be faced with an unresolved post-purchase complaint. As dissatisfaction with complaint handling is an important reason buyers give for switching brands, 114/ an effective CDRM can benefit sellers as well as buyers.

The Magnuson-Moss Act encourages the development and use of CDRMs. Under the Act's mandate, the FTC promulgated Rule 703, which imposes requirements that must be met if a seller specifies a CDRM as a part of a warranty. In a number of cases, the FTC has made the institution of a dispute resolution mechanism (though not with the full requirements of Rule 703) part of the settlement. 115/ Some industry groups have recently begun to provide CDR procedures for their members. Experimental CDRMs, limited in geographical coverage, are being tested by automobile manufacturers and by the American Automobile Association.

To give an indication of the range of CDR arrangements, we briefly discuss the details of some particular mechanisms.

b. Existing market CDRMs

The Home Owners' Warranty (HOW) program is an example of an *industry-based* program. To date, HOW is the only nationwide

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114/ See *Best and Andreasen*, *op. cit.*

115/ Typically, this has involved the requirement that the seller agree to participate in the mediation-arbitration mechanism of the Better Business Bureau and to adopt adequate recordkeeping procedures. The cases range from household furniture and appliances *Walker-Thomas Furniture Co.*, 87 FTC 26 (1976); to land sales *Great Western United Corp.*, 81 FTC 661 (1972); and sales of utility buildings and steel doors *Man Products, Inc.*, 87 FTC 217 (1976).

warranty program using a CDRM that qualifies under Rule 703. 116/ Over 600,000 houses are now covered by HOW, and nearly 25 percent of houses built in 1979 are covered. HOW provides conciliation services in the event of a dispute that is not directly resolved between builder and buyer. Failing to find resolution at the conciliation stage, the consumer may request arbitration or he may request arbitration without going through the conciliation phase. Arbitration services are provided by the American Arbitration Association. The builder is committed to arbitration if the buyer requests it and, if the buyer accepts the arbitrator's decision, the builder is bound by it. If the consumer does not accept the arbitrator's award, he is free to pursue the matter in the courts. As Rule 703 requires, there is no fee to consumers of using the HOW CDRM.

The programs run by Ford, Chrysler, and General Motors are examples of firm-specific mechanisms to deal primarily with warranty-related disputes. All of these are currently limited to certain geographical areas. The Ford program requires the consumer to negotiate his problem with the dealer before a more formal procedure is invoked. If the complaint is not resolved, a Ford representative, at the consumer's request, attempts to mediate the dispute. If mediation fails, the consumer can request review by an Appeals Board, a volunteer panel

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116/ Some of the reasons given by firms for not adopting Rule 703 CDRMs are: time limitation on dispute handling is too short; record-keeping requirements are too burdensome; set-up costs are too great and there is no opportunity to recoup costs by charging a fee for the use of the mechanism; there is no requirement that buyers deal directly with the firm before turning to the CDRM.

selected by Ford. The decision of the Board is binding on the dealer and on Ford if the consumer accepts the decision. The Chrysler program also uses arbitration by a volunteer panel, but does not have the negotiation-mediation prerequisites. Again, the arbitrators' decision is binding on the dealer and on Chrysler if the consumer accepts the decision. The General Motors program uses the arbitration services of the Better Business Bureau. None of these mechanisms charges a fee to consumers.

The Better Business Bureau (BBB) is an example of a third-party mechanism, which makes available mediation and arbitration services to parties involved in a dispute. The BBB appears to be well suited to serve as a CDRM, particularly for disputes between consumers and small businesses that are not in a position to form a CDRM at the industry-wide level. In fact, BBB is the agency most frequently contacted by dissatisfied consumers. 117/ Only a small fraction of the disputes brought to BBB reach the arbitration stage. This may be because satisfactory resolution is achieved at the conciliation/mediation stage, or because one of the parties drops out before the arbitration stage is reached or refuses to arbitrate. 118/ Experiments with programs (e.g. in

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117/ Best and Andreasen, op. cit. give survey data indicating that 22 percent of all complaints referred to a party other than the seller are brought to BBB.

118/ See S.A. Goodwin et al. "On Consumer Dissatisfaction: Consumer Arbitration as An Alternative Dispute Resolution Mechanism". They provide data on disposition of a sample of complaints brought to BBB arbitration. In 1976, the last year in the sample, 32 percent of business declined arbitration in cases where arbitration was requested by either party. The consumer declined arbitration in 13 percent of cases in which either party requested it. It is also possible that consumers drop out because the procedures or delays of the mechanism frustrate them or cause them to lose faith in the mechanism.

Seattle) in which merchants precommit to BBB arbitration indicate that such precommitment may be an effective way to organize a CDRM for small businesses. 119/

Another example of a third-party system is the Approved Auto Repair Service Program of the American Automobile Association (AAA). This program is currently in operation in eight states and covers nearly 600 repair facilities. Firms join the program after undergoing a background check by the AAA, and agree to be bound by the dispute resolution procedure of the AAA. The CDRM is operated by AAA, whose technical representatives mediate or decide complaints brought to it by consumer members of AAA. The mechanism is financed from membership fees. 120/

The development of CDRMs is in too early a stage to carve in stone specific design features. Naturally, fairness, expeditiousness, low cost, accessibility are all desirable attributes. But we are dealing here with what is essentially an infant industry. Experimentation should be encouraged and the impact of the use of particular CDRMs carefully analyzed. Equally important, the availability of CDRMs in particular industries should be publicized to consumers.

The available data appear to indicate that dissatisfaction with complaint handling procedures is concentrated in a relatively small set of industries (some of which, to be sure, command a signficiant share of consumers' dollars). These

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119/ The effect of precommitment on consumer satisfaction and the incidence of disputes is an important area for empirical study.

120/ A copy of the contract between AAA and a participating shop is reproduced in Appendix D.

include new homes, automobiles, auto repairs, home repairs, and mail order sales. 121/ This list is probably not complete, and continuing to monitor the data is no doubt necessary. Nevertheless, the studies do suggest that the hope for benefits from CDRMs is greatest in these areas. 122/ The data also suggest that in many industries outside these areas the potential benefits are more limited.

Consequently, while it may be appropriate to have firm-specific or industry-based CDRMs for some types of consumer purchases (such as houses or automobiles), in other areas mechanisms with more generalized scope should be encouraged. These include Better Business Bureaus, AAA, as well as independent, private dispute resolution services. 123/

c. Fees charged to consumers using a CDRM

An important issue concerning the design of a CDRM is the question of consumer fees. Dealing with each dispute brought before the mechanism requires the use of real resources, so that a mechanism's marginal cost of a dispute is not zero. In referring to marginal cost here, we mean only the resources expended by the mechanism in dealing with an additional dispute. Costs, both pecuniary and non-pecuniary, are also borne by the parties to the dispute. 124/

121/ See Arthur Young and Co. *op. cit.*

122/ In cases where the dispute involves technically complex issues, such as in the housing area, the costs of investigating and arbitrating the dispute are also higher.

123/ See discussion of third-party contractual agents in Section II.A.

124/ Data on the costs of operating CDRMs are sketchy. A small claim brought to BBB averages about $40 to process. For more complex claims, the costs are signficantly higher. The cost of a HOW arbitration hearing is at least $200. One of the auto companies reports a figure of about $200 for a consumer appeal that goes through its full procedure.

In consumer disputes, a case would typically be referred to the CDRM by a buyer who is dissatisfied with the seller's handling of his complaint. A strict economic approach would first view the CDRM as a service that should be paid for by those who consume its benefits. In this view, since it is the buyer who initiates the proceeding, there are arguments that the buyer should pay the marginal cost of resolving the dispute. To require lower payment than this would be wasteful and would tend to encourage frivolous or false claims. More precisely, charging the buyer a fee less than the mechanism's marginal cost of a dispute would result in some disputes being brought to the mechanism even if the expected benefit to the buyer were lower than the cost of resolving the dispute.

There are, however, arguments that can be made for setting the fee to buyers below marginal cost. These arguments turn on considerations of strategic behavior by the seller, or on informational or other spillover effects resulting from the use of mechanism. Before we discuss these arguments, it is useful to consider an important implication of having the consumer in a dispute pay less than the marginal cost of resolving the dispute.

At least a part of the seller's share of the cost of participating in a CDRM will be reflected in a higher price of the commodity being sold. Thus, all buyers of the commodity -- even those who never have disputes -- will be paying a portion of the cost incurred by those who use the mechanism.

In a sense, the mechanism becomes a form of insurance that is tied to the purchase of a commodity: insurance against the risk of having an unresolved dispute over some PPR term. Some buyers, possibly even a majority of them, may prefer not to buy this insurance and, instead, pay for the expenses associated with using a CDRM if and when the need arises. Others, however, may be sufficiently risk-averse to prefer to pay a small premium at the time they buy the commodity to insure that they can avail themselves of a CDRM at less than marginal cost. As a result, pricing below marginal cost involves a subsidy from the first group of buyers to the second. Such a subsidy may be justified on distributional grounds. Note, however, that there is no a priori reason to believe that buyers in the second group have socio-economic characteristics significantly different from buyers in the first. The subsidy may also be justified on efficiency grounds, provided that there are benefits to using the CDRM that are not fully captured by the buyers who actually use the mechanism. It is to these considerations that we now turn.

Engaging in a dispute resolution process is likely to be unfamiliar territory for most consumers. Preparing evidence; appearing before a mediator, arbitrator, or a board; arguing the case--these may involve considerable psychic and time costs. These costs may be especially significant at present, when the development of consumer dispute resolution is still in its infancy. Though the intent of a CDRM is to provide a forum that is more readily available and much less forbidding than formal judicial processes, the perception of many consumers may be to overestimate the potential costs of using the mechanism. This, together with a possible underestimate of the benefits of the mechanism, would lead to an underutilization of the mechanism if consumers were charged a price equal to marginal resource cost.

Consumers who use the CDRM do not only acquire the services of the mechanism. They also serve a "pump priming" service of providing information about the existence and functioning of the mechanism to hiterto uninformed consumers. In deciding whether to carry a dispute to a CDRM, a consumer will not take into account the external benefit that his eventual familiarity with the mechanism may help inform other consumers. To the extent that such external benefits exist, consumers' use of a CDRM should be encouraged by having them pay less than the marginal cost of a complaint. Note that as consumers become better informed--partly as a result of demonstration or word-of-mouth effects-- the arguments of this and the previous paragraph become empirically less relevant.

As the use of CDRMs become more widespread and consumers learn of the availability of relatively simple and accessible forums for resolving their disputes with sellers, the incentives that sellers may have to be recalcitrant in their complaint handling procedures are weakened. With ready access to a CDRM, a dissatisfied buyer will be less likely to become so discouraged by a seller's refusal to handle his complaint as to drop the matter. The development of CDRMs can thus exert a discipline on sellers' behavior in complaint handling, or even lead to changes in product quality. Hence, the existence of a mechanism can have potentially market-perfecting effects. The benefits of these effects are reaped even (in fact, mostly) by consumers who do not use the mechanism at all. 125/ Again, the situation is one of external benefits that are not taken into account by a consumer in deciding whether to enter into a CDRM proceeding. This implies that, at least in the early stages of the development of the CDRM idea, the fee to consumers using the mechanism may be set at a level less than the marginal cost of resolving a dispute.

The arguments of the three preceding paragraphs are based on informational and externality justifications for not requiring consumers to pay the full cost of using the CDRM. A quite distinct argument is one that asserts that in all cases (or, at least, in the vast majority of cases) the consumer involved in a dispute is in the right, and is seeking only the redress he is justly entitled to. By the time the dispute reaches the CDRM, the consumer has already incurred substantial cost in terms of time and anxiety. To impose a monetary cost on the consumer in the CDR process would, the argument goes, be adding unjustly to this burden.

The problem with this view is that, in a sense, it proves too much. If, in fact, the consumer is always right, then why devote *any* scarce resources to resolving disputes between

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125/ This possible effect of CDRMs is analogous to the effects of increased availability of information. See *CIR* report for more thorough discussion of these effects.

buyers and sellers? Any fair CDRM would invariably hold in the buyer's favor. It would therefore be inefficient to have a CDRM at all. The optimal solution would be to legislate that the consumer is always right and, in case of dispute, the seller must invariably give the buyer full satisfaction. Indeed, in a world where false or frivolous claims cannot arise, this would be sound policy. To put it another way, a world where the existence of a CDRM is necessary and efficient cannot be a world in which one side is invariably (or almost invariably) right.

One way to cope with frivolous or false claims is to allow the arbitrator to decide the allocation of dispute resolution costs. In particular, the arbitrator could decide to have one of the parties bear the entire cost or the cost could be split between the parties. For CDRMs that are financed by individual firms or industry-wide groups, the consumer who comes to arbitration could be asked for a refundable fee. All or a substantial part of this fee would be refunded, unless the arbitrator finds that the claim was frivolous. This would have the effect of discouraging some claims (primarily the frivolous ones, but not necessarily just these). In industries where the cost of a mechanism is high, the opportunity to screen out frivolous claims would tend to make firms more willing to participate in CDRMs.

Another approach involves prepayment by consumers specifically for the future use of CDRM services. This method allows buyers who do not wish to purchase such insurance to forego the CDRM option. One way to implement this approach would be for sellers to agree to precommit to a CDRM at the time of purchase if the buyer is willing to pay an additional charge for this precommitment. 126/ Working against this arrangement is the likelihood that consumers may not be well informed about the attributes of the CDRM to which the precommitment is being made. The decision about accepting the precommitment option at the time of purchase may therefore be based on fairly incomplete information. 127/ A promising variant of the prepayment approach is exemplified by the AAA auto repair program. 128/ Here, the club or organization offering the CDRM can provide information about the mechanism to the consumer, who can make the decision to buy into the plan independently of a larger purchase decision. The provider of the CDRM also has incentives in this case to monitor the effectiveness of the program and to publicize its availability.

126/ Of course, competitive forces may induce sellers to make this precommitment without additional payment, as in the Seattle BBB program.

127/ As with provision of warranties to only some segments of the market, such selective precommitment may be vitiated by problems of adverse selection. One would expect this effect to be somewhat weaker for CDRMs than for warranties.

128/ At present, AAA members in areas where the Approved Auto Repair Service (AARS) program is offered buy into the program by joining AAA. There is no explicit additional charge for AARS but, presumably, an unspecified amount of the membership fee goes to cover the costs of the program.

5. Direct Commission enforcement: mandating CDRMs

The many direct enforcement mechanisms used by the Commission and described in the Catalog Section include suits to recover consumer redress, orders requiring repair or replacement of defective products, and rules and orders mandating timely performance (violation of which trigger a substantial penalty liability). Here we discuss a fourth type: the use of CDRMs in Commission orders to resolve prospective PPR performance disputes.

For a firm with a proven record of poor performance of PPRs, when an information remedy alone cannot work, the Commission can consider mandating a CDRM. The potential benefits of such an order are considerable. The routine supervision of a firm's future compliance with an order provision calling for PPR performance can be passed on to the mechanism. Close questions that need factual investigation can be resolved there, and the mechanism can summarize and report on the respondent's PPR performance--information that can be used by the Commission to check compliance or publicized.

There are also pitfalls to consider. For a proven bad actor, the CDRM must have strong enough structure and procedures to prevent the respondent from either co-opting the mechanism, like a "captive regulator", or stonewalling it. CDRMs do not themselves have the power to compel compliance with their decisions. Some Commission oversight will probably be necessary.

Most important, in mandating a CDRM, the Commission must be especially careful to set the procedures and such terms as the cost-sharing (as discussed above regarding voluntary market--provided CDRMs) in an efficient way. Where the seller has been shown to have a record of particularly chronic or severe non-performance, there may be reasons to set more stringent standards and to consider lowering or eliminating consumer fees. The guidelines for the Commission to set the CDRM procedures will be found in the data from studies of the market mechanisms and of the mechanisms required under past FTC orders.

As with mandating warranties, refunds and the other PPRs themselves (which is discussed at length in the following section), any Commission rule or order that requires enforcement through CDRMs should be based on the careful scrutiny of its costs and incentives. One strategy to minimize this problem is to combine the required CDRM with an information remedy, and "sunset" the CDRM when the information shows that the performance problem has disappeared.

One good feature of supplementing the existing, but inaccessible, legal system of PPR dispute resolution with cheaper, accessible CDRMs is that it will reduce the risk to all parties of any disputes arising. 129/ The auto companies

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129/ This operates in the same way that mandating a warranty can induce sellers to improve quality and reliability and reduce life-cycle costs, as is discussed in the following section.

now providing voluntary CDRMs have reported that the biggest impact has not been the mechanisms decisions, but the reduction of disputes because dealer and customer service personnel are more concerned with resolving the problems early because the mechanism is there. 130/ But there is much about how these mechanisms operate that we do not know.

6. Advantages and disadvantages

The advantages and disadvantages of information about PPR performance are discussed in the preceding section. For Commission interventions that require sellers to set specific performance standards in the contract, the primary advantage is that these give the buyer and seller an explicit limit that can be enforced informally or, if the buyer must resort to a CDRM or a court, one that can be enforced easily. A flexible standard that can be varied in the contract (but not left out of the contract) has the advantage of permitting the market to set the optimal standards for different sellers and consumers, assuming that enough consumers are aware of the contract term and care about it.

Standard-setting inevitably involves some reduction in flexibility. Firms that must set and meet explicit standards may misestimate and then be unable to meet the standard for some unforeseeable reason; this poses a risk of losses to the firm. Furthermore, a firm failing to meet specific performance standards will not then necessarily provide the called-for

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130/ Testimony of Grant C. Chave, Ford Motor Co., Subcommittee on Consumer Protection and Finance, House Interstate and Foreign Commerce Committee, H.R. 1005, July 24, 1979.

remedy; in other words, the costs of Commission or private enforcement remain for those contracts not fully performed.

Dispute resolution mechanisms reduce the effect of the market failure of high enforcement costs. They also permit consumers to select what claims to pursue and sellers to select what PPRs to offer. Where CDRMs are offered voluntarily, they are reacting to a real marketplace demand. However, CDRMs themselves are costly. Moreover, there are subtle features of the structure and procedures that need to be scrutinized to insure that the mechanisms are fair, accessible, and work promptly. Finally, the decisions of CDRMs are not self-enforcing, and Commission oversight or private resort to courts may be needed to see that mechanism decisions are carried out.

D. MANDATING PPRs: COOLING-OFF AND TRIAL PERIODS

In this section we discuss two closely related PPRs which the Commission has mandated for particular firms, types of selling (e.g., door-to-door) and for particular services (vocational schools). Cooling-off and trial periods both delay the finality of a contract and permit the buyer to cancel the agreement. An extensive discussion of the costs and benefits associated with these remedies is provided as well. In the following section we consider the other PPRs that the Commission might require of sellers: warranties and refunds.

A cooling-off period is a remedy clause in a contract giving the buyer an opportunity to cancel within a specified period of time. There may or may not be an explicit charge for this option. 131/ Cooling-off has been widely used as a remedy by the Commission: the trade regulation rule governing door-to-door sales allows purchasers three days in which to consider their purchases; the rule on vocational and home study schools allows 14 days. Cooling-off provisions have also been incorporated into orders concerning the sale of land, encyclopedias, and invention promotion services. 132/

131/ Such options are occasionally incorporated in market contracts, although their avowed purpose may be different. For example, contracts to purchase homes sometimes contain a contingency making the sale subject to a satisfaction inspection by the purchaser. In fact purchasers sometime use this provision to avoid a contract where a better buy becomes evident during the inspection period.

132/ Horizon Corp., 3 CCH Trade Reg. Rep. ¶21,621, Docket No. 9017 (September 21, 1979)(initial decision); Encyclopedia Britannica Inc., et al., 87 FTC 421 (1976), aff'd Encyclopedia Britannica, Inc. et al. v. FTC, 605 F.2d 964 (7th Cir. 1979); Idea Research and Development, Inc., 89 FTC 31 (1977).

It has been suggested that cooling-off provisions might serve a useful function in any large consumer purchase. Although the consumer may sample a service or receive goods during a cooling-off period, it is generally the practice of sellers to delay delivery until the sale is final.

Trial periods differ in that they do not begin to run until the buyer has an opportunity to sample the service or to receive the merchandise under the sales contract. During the trial period the buyer can cancel the contract (returning any goods) for any reason, even because the sale is not "satisfactory". (This contrasts with mandatory warranties against defects in merchandise.) The Commission has required trial periods for a reducing salon that sold long-term contracts for services, 133/ and one order has required a seller to permit buyers who purchase investment land sight unseen to cancel after an on-site visit within one year. 134/

1. The rationale for cooling-off and trial periods

Cooling-off has traditionally been applied to achieve two goals: 1) to protect consumers from high-pressure sales tactics and 2) to reduce misrepresentations as to price and quality by providing opportunities for post-purchase comparison shopping. 135/

133/ *NU Dimensions Figure Salon*, 81 FTC 797 (1972).

134/ *Horizon Corp.*, (initial decision), *op cit.*

135/ These two functions roughly correspond with the equity and efficiency goals discussed in Section II.

The Commission has found that when a salesman enters a consumer's home, critical defenses maintained for in-store purchases, such as skepticism and a sense of impersonal "distance" from the seller, are more readily broken down. Persistent salesmen can often capitalize on individuals' natural reluctance to force an invited guest back out the door. The opportunity to deliver sincere pleas in an atmosphere associated with family, friends and security can be a powerful sales tool. In addition a salesman's visit can heighten the sense of a singular opportunity to purchase a valuable item, thus exaggerating urgency and encouraging impulse buys. 136/ The argument for limiting sales under such circumstances is based partly on equity considerations 137/; it is also based on efficiency, though, in that purchase decisions made under such circumstances are inconsistent with the assumptions of the perfectly competitive market with complete information.

Other high-pressure sales techniques have been identified as justification for cooling-off and trial period remedies. Trial periods have been used where it is particularly difficult to measure in advance the value or efficiency of a product or service.

A second basis for cooling-off is that it allows consumers an opportunity to comparison shop and judge the accuracy of a salesman's claims of product or price superiority. Cooling-off provides consumers with a brief perion in which to accumulate some

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136/ Statement of Basis and Purpose, Cooling-Off Period for Door-to-Door Sales, 37 Fed. Reg. 22934, 22938, esp. n. 41 (October 26, 1972).

137/ See the discussion of equity considerations in Section II.C.

additional information; trial periods permit the buyer to sample or inspect the purchase. Consumers presented with a "one time only" land sales offer, for example, have an oppotunity to survey surrounding parcels in order to compare them with the offered land.

Trial periods similarly counteract high-pressure sales techniques and permit more information-gathering before the sale is final. They are particularly helpful where the buyer should sample the product or service for some time in order to adequately judge value and quality.

In most cases the impetus for applying these remedies is the unfairness of high-pressure sales techniques. The shopper who voluntarily enters a place of business in search of a purchase is not only likely to be better prepared to resist a high pressure sale than one approached at home, but he or she also need not rely on the salesman's representations as to price and value, since the store's offer will usually still be available after a comparison of competing products. Where buyers have an opportunity to comparison shop without significant costs imposed by the seller, 138/ the rationale for cooling-off and trial periods provisions are not as strong.

138/ Thus a high pressure seller who offered buyers a "good price" but a less favorable one if they took time to comparison shop his offer would not be beyond the reach of cooling-off under this theory. Nor would a similar seller who promised a "money back satisfaction guarantee," but made return of the purchaser's money contingent upon her incurring significant costs to return the merchandise (postage, insurance, etc.) or possibly subject to a local manager's determination as to whether the return were for good cause.

2. Costs and benefits

a. Incentive compatability

The cooling-off and trial period PPRs encourage buyers and sellers to reduce the risks of both parties associated with the sales transaction: for buyers, the risk that they will pay too much for the value received is reduced; for sellers, the risk that buyers will default on their purchases is lessened. This makes these remedies incentive compatible.

A primary expense for sellers is the time they devote to the sales presentation. Sellers are aware that cooling-off and trial periods provide consumers with an opportunity to further consider the purchase and discuss it with friends and family. Consequently, sellers place themselves at a disadvantage if they make a sale based on exaggerated or deceptive claims that could be discovered by buyers within the remedy period. It is to the seller's advantage, then, to present his products in such a way that subsequent consideration will not leave the consumer disappointed with the purchase or suspicious of the salesman's integrity.

Similarly, because sellers realize that buyers have time to consider their purchases, high pressure techniques may be less effective than other sales techniques that encourage favorable post purchase reflection. This might encourage sellers to provide buyers with more substantive product information.

As for buyers, cooling-off encourages them to comparison shop. This can take the form of a formal effort to acquire post-purchase information about competing products, or more informally through conversation with friends. Cooling-off also allow buyers time to separate their initial enthusiasm for a product from a considered evaluation of their ability to pay for it. Many sales to which cooling-off apply are installment sales. Because door-to-door credit sales take place without time for pre-purchase reflection (such as the unanticipated appearance, sale, and purchase of an expensive encyclopedia from a door-to-door salesman in one evening), buyers may subsequently realize that they have incurred a debt they cannot really afford. To the extent that this post purchase reflection removes potential defaulters from the contract pool, sellers also benefit: it reduces the risk of defaults.

b. Economic costs

Cooling-off entails some direct economic costs. Printing, processing, and recordkeeping costs result from the requirement that sellers supply consumers with printed cancellation notices; other costs result from sellers having to cull from orders those for which buyers have cancelled. 139/

There is an additional cost to firms in cancelled sales under cooling-off and trial period PPRs. These are likely to be of two types: (a) sales which might ordinarily have been made through unfair or deceptive practices but which

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139/ We have no reliable data on such recordkeeping costs.

cooling-off and trial periods prevent, and (b) sales to persons who purchase at least partly because of the security provided by the required remedy term, but subsequently use the remedy to cancel their orders. The first group cannot be claimed as a social cost because the sales it represents were unfairly obtained in the first instance. However, prices to interested purchasers may be higher because they are no longer subsidized by unfair sales, so the rule may have some redistributive effects. The second group--those who sign knowing they can cancel--presents costs if they sign with no intention of buying, perhaps because it is easier than saying "no" to a persistent salesperson. Others in this group sign even though they are only somewhat interested in the purchase, and decide to go ahead with it during the cooling-off period. Conceivably, the remedy provisions could even increase total sales, if enough of these buyers learn that they really do want the product.

There is also a possibility that sellers who deliver merchandise prior to the expiration of the cooling-off period will incur increased costs in recovering that merchandise. This could range from the actual costs of physical recovery (guaranteed postage, or an extra trip by a salesman) to the legal costs raised by a buyer's refusal to return merchandise. This cost is within the seller's control, since he can simply delay delivery until the cooling-off period has expired.

Finally there is a very slight uncertainty cost to sellers because they are unable to state positively the number of firm orders outstanding at any particular moment. However, the short duration of most cooling-off periods should reduce this cost to virtually nothing.

All of these costs are passed on to consumers in one way or another, either as an increase in the price of goods or occasionally an unwanted delay in their reciept, or both. These increases may be sufficient to decrease the provision of sales subject to cooling-off in the market, a consequence not intended under the remedy. In the case of door-to-door sales, this loss would be particularly heavily felt by immobile consumers (primarily the elderly and the poor) who could not easily get to downtown stores, and who depended on the door-to-door salesman for access to the market.

Lastly, implementing the rule involves some effort on the part of consumers, such as reading additional material and posting necessary forms.

c. Economic benefits

Cooling-off lessens the number of sales in which persons are figuratively browbeat into purchasing expensive products they do not "really" want and thus promotes the channeling of economic resources into more genuinely desired purchases, i.e. those that withstand longer term consideration. Trial periods permit buyers to compare the goods or services delivered with the representations made by the seller. By encouraging comparative shopping, cooling-off further promotes the efficient allocation of economic resources by helping buyers obtain maximum utility for a given price.

An unintended effect of these PPR terms is that buyers need exercise less care and effort in resisting a salesman's blandishments that they enter a contract. Some buyers may enter contracts just to rid themselves of the high pressure sales pitch and then cancel. 140/ This is a moral hazard problem. A long-term effect may be that the seriousness with which buyers approach contractual obligations may be reduced or that some persons may enter and then fail to cancel unwanted contracts through inadvertence.

It is difficult to say in general whether the economic benefits of these remedies outweigh the economic costs. By allowing consumers with second thoughts about a purchase to withdraw prior to receipt of the merchandise the number of persons likely to refuse delivery or fail to make payments is undoubtedly reduced. The savings to sellers in shipping, collection and court costs from not having to deal with doubtful buyers may offset the cost of the rule's operation.

d. Restrictiveness

The restrictiveness of a remedy is a function of the kinds and range of possible contracts which it precludes from the market. As the preceeding section suggests, the actual economic costs of imposing cooling-off are not great.

140/ Although this may raise costs, as discussed in the preceding section, its ultimate effect should be to reduce high pressure sales. The high pressure saleman who increases the "pressure" of his sales pitches in order to offset nugatory contracts is likely to encounter an even greater number of rejections.

Relatively few transactions will become so expensive that they are discontinued. Thus, as a means of eliminating high pressure sales, cooling-off is obviously preferable to an outright ban on sales in high-pressure environments. A ban is more likely to do unintentional harm, by limiting consumers' access to market-perfecting information. Cooling-off is more likely to restrict only sales which are unfair and deceptive.

Trial periods are similarly less restrictive than a ban on selling techniques deemed to be "high pressure"; moreover, they do not pose the obvious enforcement costs of that alternative.

3. Applying cooling-off

Since cooling-off is designed to insulate consumers from high-pressure sales techniques and give them an opportunity to reflect on their purchases or comparison shop, it is most useful when applied to high-pressure sales situations that also do not permit comparison shopping. Even in these cases, cooling-off should only be imposed if it is the least restrictive effective remedy. How might the Commission be guided in choosing those situations and products?

One possibility is not to view this problem from the perspective of an enforcement agency but rather from the perspective of the purchasing consumer. Modern marketing techniques place less emphasis on selling a product and greater emphasis on determining how best to match consumer concerns and the manner of sale. An analogous shift in the Commission's view of cooling-off questions might be useful.

From a consumer's point of view all purchases carry some degree of risk. If the product is one with which the buyer is familiar, the perceived risk is very small. If the product is one with which the shopper is unfamiliar and costly, the perceived risk is high.

Perceived risk is a function of both consumer and product characteristics. It tends to be higher when 1) the price of the product is high relative to personal income; 2) the consumer is unfamiliar with the product and requires information to understand the product's characteristics; or 3) a product is infrequently purchased.

Examples of high risk products are videotape recorders, new automobiles, investment land, and so on. These require a lot of information to be sold, and manufacturers accomodate by providing for higher margins and limited distribution necessary to support these sales. Low risk products do not carry as high a perceived risk nor require individualized selling. They are generally low priced, low margin, high volume products such as those typically found in a supermarket or discount store. They are often impulse purchases. Some products, such as electronic calculators have been sold as both high and low risk items during their product life cycle. When first introduced, they were high margin products sold through business supply dealers who were able to advise consumers as to the best purchase. As their price dropped and consumers perception of calculators changed from high risk to a safe, known product, profit margins were reduced and calculators were moved into discount stores.

The problem for consumers arises when sellers adopt a sales strategy that relies on high pressure to convince consumers to treat a high risk transaction as if the risks were lower. Parents may perceive a high degree of risk in finding an encyclopedia suited for their children; they might ordinarily want to make some inquires and examine competing sets. A seller wishing to minimize their concerns might administer a test that "proves" his is the best encyclopedia for their needs; or the seller may lend a sense of urgency to closing the deal quickly, perhaps by stating that this is the last night that he is authorized to offer a limited number of showcase families a "special" price on the set. These efforts to persuade the buyer to treat a high risk product as a low risk purchase and to lead the consumer to make decisions they would not have otherwise made, should concern the Commission.

Viewed in this way some of the pitfalls inherent in the Commission's consideration of cooling-off might be avoided. For example, perceived risk tends to increase when the price of a product is high relative to personal income. The Commission has recognized this by exempting trivial purchases; the Cooling-Off Rule for door-to-door purchases does not apply below $25.00.

Where cooling-off might be applied to a particular product or service, it should be considered that perceived risk also varies with familiarity with the product. Electronic calculators, mentioned above, are one example of a product for which the associated risk has changed as price has declined and familiarity increased. As the Commission considers new proposals it should consider where in this cycle a particular product is. A rule proposed in 1972 applying cooling-off to calculator sales, although justified at the time, would be unnecessarily restrictive today.

Such a system of analysis can go only so far. Marketing theory itself is as much an art as a science. However a sensitivity to perceived risk and the manner of sale can help to focus the direction of the Commission's efforts.

4. Applying trial periods

This remedy should be considered in many of the same high-pressure settings, but is preferred where the product or service is one which is difficult to evaluate upon a simple inspection. The more difficult issue here, though, is whether the seller should be permitted to keep some portion of the sale price for services rendered in connection with the sale, or for the reduced value of returned goods that are then "used" merchandise.

5. Advantages and disadvantages

To recapitulate, cooling-off permits comparison shopping, and trial periods permit the buyer to gather information from direct experience with the product or service. Both PPRs permit consumers to make purchase decisions free from high-pressure sales tactics. As a result, these remedies discourage deception.

However, cooling-off and trial periods entail administrative expenses; the latter, when applied to a product, leads to a depreciation cost for returned items. Finally, both remedies may reduce consumer care in entering contracts.

E. REQUIRING POST-PURCHASE REMEDIES: WARRANTIES AND REFUNDS

It is not uncommon for consumers to express dissatisfaction with product performance, the quality of services and the level of post-purchase protection offered in the market. 141/ Assuming that the cause of this dissatisfaction is a market failure, the question then becomes whether a fair and efficient remedy can be designed and implemented. Designing the best remedy will depend heavily on the sources of market failure 142/ and on the predicted responses of buyers and sellers to the new formula of risk sharing embodied in the remedy, especially the incentives it creates for each group. From a strict viewpoint of efficiency, though, consumers will be aided by a policy of broader post-purchase protection (broader than the market currently provides) if the value they attach to the increased protection exceeds the price the market requires to supply this protection. Otherwise, costs to all may increase, and consumers may be better off without the added PPR protection.

This section discusses Commission interventions which require a seller or sellers to offer a prospective warranty, refund, replacement, or repair to consumers whose product or service turns out to be "defective". Where a warranty or other PPR is already offered, the analysis would also

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141/ Defects in consumer products, unsatisfactory services and unfair contract terms are perennial leaders in polls of voiced consumer complaints. See, *e.g.*, Federal Trade Commission "Digest of Consumer Complaint Correspondence, First Quarter, Fiscal Year '80'," *op. cit.*

142/ See discussion in Section III.A.

apply to a requirement that the PPR coverage be broadened -- for example, that it cover more kinds of defects, assume a greater share of the risk covered, or run for a longer time. 143/

The first subsection examines remedies which fix the warranty or refund terms for a broad class of contracts prospectively -- that is, before any specific product failure has come to light. The following subsection discusses the imposition of warranty or refund obligations retrospectively, extending only to specific defects which have already been identified in a particular brand or make of product. While there are many similarities between these two methods of mandating PPRs, their differences are sufficient to warrant spearate treatment.

1. Mandating PPRs prospectively

The merits of intervening prospectively to fix the warranty or refund term of a contract depend in part on the reasons why the market was not producing an optimal PPR. That is, the decision must begin with an analysis of the market failure. As the Overview section noted, if the source

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143/ Bans on deceptive warranty terms -- e.g., "Baldwin Piano" clauses which make the promises of the rest of the warranty worthless as a practical matter--are not covered here. In one sense, a ban on such a term is a form of a required PPR, because it requires (in effect) that any warranty offered cover shipping costs or provide for in-home service. However, this requirement is necessary to prevent the seller's description of the warranty from becoming illusory, or deceptive, so this remedy has already been discussed as an "information intervention" in Section III.B.

of the market failure is the seller's monopoly power (reducing the pressure on the seller to respond to consumer needs), a remedy mandating some higher level of PPR performance is not likely to make consumers better off. 144/ If the market failure is due to a lack of information about product failure rates or about the PPRs offered, though, the analysis is more complex.

a. Mandating PPRs to solve an information problem

If the product quality or PPR competition is limited by a lack of consumer information, the intervention usually called for is an improvement in the information available to consumers. Under certain circumstances, however, it may be very costly for the Commission (or for any private party) to collect this information and communicate it to consumers in a timely and effective manner. In this case, an alternative strategy is to madate those particular PPR provisions that buyers would desire, if they were better informed.

To illustrate, consumers of a particular product or service may fairly consistently underestimate the likelihood of failure, leading to an inefficient level of PPR in the market. Studies and surveys can demonstrate what PPR consumers would choose (and at what price) with better information, and this can be studied for its potential effects

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144/ Section II.B; see also Section III.A. The Overview section also noted that the presence of a noncompetitive market structure did not necessarily imply that a suboptimal PPR would be offered, so there will not always be any problem to correct.

on incentives of buyers and sellers to reduce risks overall. This is the approach taken, for example, in the land sales cases in which the order permits the buyer to get a refund after first inspecting the land site within a year of purchase. 145/ Because consumers who buy land sight unseen take such great unrealized risks that the land will not have the features promised or suggested by the seller--such as being suitable for development as a resort, or for investment--the order requires a clause that buyers would want if they fully appreciated the risks.

However, this remedy has its costs in terms of reduced marketplace flexibility. If the Commission is to act as consumers' agent in this way, the preferences of potential buyers must be analyzed in order to choose the most preferred and cost-effective PPR to mandate. In most cases, consumers will not all have the same preferences or needs, so they must be balanced by the Commission, and some consumers are likely to be dissatisfied. In addition, once the PPR is in place it will have to be periodically monitored and re-evaluated. A PPR which was optimal at one time will no longer be optimal if consumer preferences or other market conditions have changed, and continuing to mandate that specific PPR in such a case may make many consumers worse off rather than better.

145/ Horizon Corporation, 3 CCH Trade Regulation Reporter ¶21,621, Docket No. 9017 (1979) (initial decision).

These difficulties will be reduced somewhat if the PPR is made semi-optional -- e.g., by requiring it only if the seller chooses to offer any kind of a warranty, thus leaving sellers the option of offering no PPR at all. An even less restrictive remedy would be to define several levels of standardized PPRs, and allow sellers to choose among them (and to change their choices as market conditions change). However, too much flexibility will defeat the purpose of the remedy, and lead to the reassertion of the same market forces which led sellers to offer suboptimal PPRs in the first place. Thus, there is an inherent tension between market flexibility and mandating PPRs, and any successful attempt to mandate a higher level of PPR coverage will involve some sacrifice of market flexibility.

b. Enforcing mandated PPRs

Another difficulty with mandating PPRs is that inserting broader remedies in the contract will not necessarily increase the protection that consumers actually receive. Sellers may respond by failing to live up to the mandated PPRs, or by otherwise reducing the quality of PPR performance. Since a mandated remedy makes some market participants do something that they would not otherwise choose to do, there will often be incentives for some buyers and sellers to circumvent the remedy. In some cases, these incentives may be very strong. The difficulties agencies sometimes have policing firms' performance of safety repairs under product recalls is an illustration of this problem.

Of course, if consumers could costlessly enforce the proper level of PPR performance (or had information about which sellers were most likely to perform), this would not be a problem. 146/ As we have seen, though, the costs of consumer enforcement often preclude these mechanisms from serving as an adequate check on sellers' PPR performance. Thus, any attempt to mandate PPRs will probably have to deal with this market failure as well, either by providing for direct Commission enforcement, by reducing the costs of consumer self-enforcement, and/or by giving consumers better pre-purchase information about sellers' performance under their PPRs, 147/ These measures will obviously add to the costs of a remedy; to the extent that they are not entirely successful, they will also reduce the remedy's effectiveness.

c. Adverse selection problems

As the Overview section noted, problems of adverse selection may prevent the market from offering the optimal level of PPR protection for some products. That is, there may be some consumers who would be willing to pay enough to cover

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146/ If consumers lack information about the risk of product failure, they will not necessarily *want* sellers to give full PPR performance, and these incentives will be doubly weakened: Consumers who do not appreciate the seriousness of the product risk may well be attracted by sellers who do not fully perform their PPR obligations, and thus are able to offer a lower price.

147/ See Section III.C. for a more detailed discussion of these remedies.

the costs of expanded warranty protection, but if sellers are unable to identify them or to exclude higher risk consumers, the expanded warranty may never be offered. Offering the expanded warranty to the public at large would attract high-risk consumers as well, thus raising the cost (and the price) of the warranty possibly beyond what the lower-risk consumers would be willing to pay.

Where adverse selection is a problem--i.e., where sellers cannot distinguish the low-risk consumers--mandating extended PPR coverage may not be very successful. Adverse selection will operate in the same way on a mandated PPR, as sellers raise their prices to reflect the average cost of providing extra protection, thus making the protection less attractive to those whose costs are likely to be below average. As those consumers drop out of the market (or switch to some other seller) 148/ the remaining consumers will be the ones with higher average levels of risk, requiring sellers to raise the price of protection even further. The upshot is that, unless some way can be found to distinguish high-risk from low-risk customers and price to each group separately, the price of the mandated PPR will eventually rise to the level necessary to cover the costs of those at the higher end of the spectrum.

148/ The problem of adverse selection is most severe if the extended PPR is mandated for only a single seller, thus leaving low-risk consumers the option of switching to other sellers with lower protection and lower prices. An industry-wide rule would reduce this problem -- but it would also increase the costs to low-risk consumers by depriving them of this option.

All other consumers will either be charged more than the protection is worth to them, or will have decided to go without protection entirely. This will obviously reduce the benefits of the remedy.

The Overview section also noted that, for some products, customers can be sorted and priced separately on the basis of risk. Automobile warranties offer varied protection (or prices) on the basis of the car's mileage; similar metering devices may someday be feasible for other consumer durables (e.g., washing machines) whose likelihood of breakdown varies with their amount of use. Where such devices can be developed, the problems of adverse selection can be controlled, but the costs of measuring devices (or other risk-distinguishing techniques) will be an additon to the total costs of the remedy.

d. Moral hazard problems

For some kinds of mandated PPRs, similar problems relating to moral hazard may be present. While extending the PPR coverage may increase sellers' incentives to make sure that the product performs up to their representations, the extension of coverage may simultaneously reduce the buyers' incentives to take steps to insure proper performance. If the product is one where the buyer's behavior (*e.g.*, carefulness of use or extent of preventive maintenance) has a significant impact on whether the product performs properly, mandating increased PPR coverage could actually increase the incidence of unsatisfactory performance.

Of course, not all product defects fall into this category. Some -- e.g., structural housing defects -- are not influenced by buyer behavior, and thus pose no moral hazard problems at all. For other defects, even the most extensive warranties still require the buyer to incur significant costs (largely the time, annoyance, and effort involved in getting the product exchanged or fixed), and thus preserve some incentive to maintain proper maintenance and use. For other products, though -- especially where the standard of "defect" under the PPR is a subjective one tied closely to the buyer's satisfaction -- the effect on buyer incentives may be greater. Further empirical research on the effect of PPRs on consumer behavior would obviously be useful; at present, all we can say is that the possibility of increased moral hazard problems should always be explored and taken into account.

e. Availability of optional remedies in the market

A final consideration is that arguments for mandatory warranty coverage are weakened in markets where optional remedy terms are already widely known and available; for example, service contracts or product leases with repair coverage. [149] Consumers in these markets already have the option of shifting the risk of failure to the producer or a third party if they choose. Under reasonably competitive conditions, and absent information problems or equity problems such as high pressure sales, the price of this additional protection should reflect the market cost of providing the risk transfer. Mandating coverage so that all consumers get as much as some now choose to purchase will reduce the options available to consumers, and will not reduce costs.

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[149] This would not apply to the housing market, where there are significant differences between buying and leasing, that do not apply to furniture, appliances, automobiles, etc. Owning a home has important investment and security features that do not apply to other durables.

To illustrate, consumers who want a new car and protection against repair costs can buy a car with a limited warranty only, purchase an optional extended service contract, or lease a car under an agreement wherein the lessor makes all repairs. Naturally, the cost of these options increases as the risk to the consumer is reduced. 150/ However, if the law were to mandate longer warranties for new cars as a remedy for product quality problems in the auto industry, we would in effect be requiring all new car consumers to purchase service contracts. Given that consumers currently have the option to do so and many apparently choose not to, it seems likely that, in this case at least, mandating extended warranties would harm consumers more than help them.

2. Mandating PPRs retrospectively

Another method of dealing with product quality problems is to adopt a case-by-case approach in which the liability for repairs is shifted to the seller retrospectively, and only for specific product failures which have already come to light. The Commission has obtained orders calling for

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150/ Full maintenance and repair in a leasing arrangement costs $25 or more per month; service contracts covering only defects in the "major mechanical systems" of a car for the period of 12/12,000 to 36/36,000, with a deductible provision, start at $5 per month.

refunds for repair costs and for extended warranties for specific product design defects in two cases, Fedders 151/ and the Ford "piston-scuffing" case 152/ (which involved three separate defects). The Commission has also reached similar settlements in cases involving services which were unsatisfactory or not up to their advertised quality. 153/

Mandating liability for repair or replacement retrospectively will usually be less costly than mandating a PPR prospectively. The seller's liability can be limited to defects for which the problems of moral hazard and adverse selection are less severe, thus reducing or eliminating those costs. Further, a retrospective policy can be limited to only the most serious problems, thus protecting consumers from significant losses, while relying on the market to solve less significant failings. This serves like a deductible clause in an insurance policy to keep costs down.

On the other hand, the difficulty of enforcing the seller's obligations under the PPR will still be a problem, just as it was in the case of PPRs imposed prospectively. Moreover, since a retrospective PPR is imposed only after the product has already been produced (and the defect has come to light),

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151/ Fedders Corporation, 93 FTC 949 (1979).

152/ Ford Motor Co., Docket No. 9105. A provisionally accepted consent order was published for comment in 45 Fed. Reg. 13115 (February 28, 1980).

153/ Fuqua Industries, C-2626, 85 FTC 93 (1975); Weaver Airlines Personnel School, Inc., C-2638, 85 FTC 237 (1975), modifed 87 FTC 1288 (1976).

the benefit of giving the manufacturer an incentive to take cost-effective steps to produce a more reliable product will be at least partially lost. Of course, this incentive will still be present to the extent that the imposition of a retrospective PPR signals that future defects will give rise to the imposition of similar PPRs. The rule of law which emerges from a series of such orders, giving the conditions under which a PPR will be imposed retrospectively, will give manufacturers an incentive to take steps to avoid the imposition of such PPRs in the future. However, once this point is reached, the distinction between imposing a PPR prospectively and retrospectively will have largely disappeared. The price of goods will rise to cover the possibility that a defect will arise which will trigger the imposition of a PPR in the future, and consumers will thus (in effect) be purchasing a PPR prospectively. The important questions to be answered are thus essentially the same as in the previous case: Do consumers value the increased protection more than it will cost them to get it? Is there a less costly method of achieving essentially the same goal?

The manufacturer operating under such a PPR policy (once enough cases have elaborated a standard) will include a premium in the price of his product to cover the possibility that his design decisions will result in unforeseen failures which he will have to repair. The manufacturer may also react by becoming more conservative 154/ in making design changes,

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154/ This argument assumes that reputation and repeat purchases are not important enough for the producer to suffer sufficient losses from his design mistakes. See Section III.C *supra*.

which may have both positive and negative aspects for the consumer. To the extent that worthwhile cost-saving design changes are not introduced as a result (that is, innovation is inhibited), consumers may suffer a loss; on the other hand, the manufacturer will increase the testing and research he does before introducing a design change, and as long as these increased costs are less than the expected losses consumers might have borne from the bad design decision, consumers will gain from this increased caution.

3. Evaluating required PPRs: cost-benefit

The considerations just discussed provide useful guidelines in narrowing the search for a remedy. The fundamental question in any decision to prescribe a contract remedy term, though, is whether the intervention succeeds in providing consumers with a product quality/warranty package that they value more than it costs the market to provide. This involves comparing the consumer demand price for the proposed alternative (i.e., what consumers would be willing to pay) to the market supply price (i.e. what it would cost sellers to provide the alternative). 155/ While even a careful statistical study may not give us precise figures for this, it can provide some guidance for setting policies that shift liability, as the following example illustrates.

155/ See discussion in Overview, Section I.A.

For simplicity of analysis, first suppose that changing the level of warranty coverage has no effect on the level of product reliability offered in the market or on the level of care exercised by consumers. 156/ Consumers' demand prices, then, are simply what they would pay for increased insurance against product failure. If the costs to them of product failure are significant, it is reasonable to assume that consumers are risk averse; we can therefore predict that they would be willing to pay some premium over the expected costs of product failure in order to pass on the risk of product failure.

As an example, suppose that an appliance offered in the marketplace has one chance in 10 of failing, and that the cost to consumers of having the needed repairs done is $500. Thus the expected repair costs are $50 (1/10 times $500). If consumers are risk averse, they would be willing to pay more than $50 to shed the risk of a financial loss of $500. How much more will depend on each particular consumer's risk aversion -- that is, how high a premium they are willing to pay to avoid having to bear the risk of an uncertain expense.

These expected cost savings for a given consumer are based on the costs to the consumer of having the product repaired himself. The costs to the producer of making the

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156/ We change these crucial assumptions below, and assess the impact of the warranty on the reliability of the product produced.

same repair are not necessarily the same. For some kinds of repairs the seller has better expertise than alternative repair sources available to consumers; the seller may also be able to economize on transactions costs. However, some kinds of product failure are likely to involve greater costs for the seller to remedy than for the consumer. For example, a consumer can probably fix a simple flat tire for less than it would cost tire manufacturers, if they were required to fix all flat tires. 157/ In summary, the expected cost savings to consumers of expanded warranty coverage are not always the same as the expected repair costs of producers.

The market supply price is the cost to sellers of a remedy term, such as expanded warranty coverage. The seller's costs include the cost of the repair itself plus administrative costs. Sellers also put a cost on the risk they must now assume, determined by their particular aversion to bearing risks. This will increase as the total expected repair costs become larger relative to assets or sales, to the extent to which the total repair costs are subject to greater variability. These factors suggest how risk averse sellers are likely to be, and thus how much they will charge to assume the risk.

157/ In fact, the comprehensive coverage for all "road hazards", once commonly found in tire warranties, is not widely available today. The reasons why this feature was dropped from tire warranties is not clear, but one possible reason is that it was not cost-effective as suggested here.

However, in estimating the market supply price of expanded coverage we must also take moral hazard into account--that is, the danger that consumers may be less careful in using the product and in doing needed maintenance, if warranty coverage is expanded. For example, suppose an extension of warranty coverage on an appliance to a ten year full warranty is considered. Even if producers have good information from past evidence on lifetime repair costs, an extension of warranty coverage to ten years might in itself have an effect on the realized rate of product failure. This is because consumers having a ten year warranty could employ less care and self maintenance in the use of the product. Where moral hazard is a significant problem, expanded coverage would not be incentive compatible, since consumer response would be to increase the risk, and thus increase costs to the market disproportionately. 158/

Moreover, we have assumed so far that expanded warranty coverage will have no effect on the level of product reliability offered in the market. This generally will not be a reasonable assumption, especially for any significant expansions of coverage. More commonly, a significant expansion in warranty coverage should increase the reliability of products. To

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158/ A very real check on this disincentive for care is the considerable costs and inconvenience of having repairs made; even where the direct costs are the seller's liability, the consumer pays a high "deductible" in the form of time and inconvenience.

the extent that this obtains, sellers choosing greater product reliability will do so because it is cheaper to devote increased resorces to improving reliability than to make the repairs associated with the expanded warranty.

If improved product reliability can be predicted, the costs and benefits outlook of a proposed expanded remedy can be adjusted in this way. First, the market supply price for the remedy will be lower than predicted when assuming a fixed level of product reliability, because an improved design will need fewer or cheaper repairs. (The cost of making the design change must be considered, but overall it should reduce seller costs.) And consumer demand price can be adjusted upward because it is likely that any improvement in reliability will have a lasting effect after the warranty period, lowering expected repair costs for consumers.

The studies now being done for housing 159/ and the one already done for used cars 160/ are examples of the kinds of measures of demand prices or supply prices that can be made to assess the impact of various proposed liability policies.

Finally, in many cases the analysis of costs and benefits of a given intervention will indicate that, while some buyers

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159/ Mathematica Policy Research, Inc., "National Survey of Defects in New Housing" (forthcoming).

160/ Study by Wisconsin Center for Public Representation. Staff Report, Sale of Used Motor Vehicles, Bureau of Consumer Protection (September 1978) pp. 19-24.

will be made better off by the intervention, others will lose as a result of the change. For example, a mandated warranty shifts costs from the careful user who makes few claims to the less careful user. Of course, this effect applies to all warranties now offered in the market, where consumers who pose different levels of risk and who have differing risk aversion are grouped together (e.g., virtually all new washing machines have the same 1 year full warranties to all buyers). Wherever there is such a shift, the Commission should be aware of the redistributive implications of its remedy.

4. Summary of advantages and disadvantages

In short, the principal benefits of extended warranty coverage are twofold. The extended protection compensates consumers for instances of product failure (thus satisfying their demand for insurance) and gives sellers incentives to take all cost-effective steps to reduce the frequency of failures. On the other side, though there are a number of costs which must be taken into account. Providing the warranted repairs (or refunds or replacements) is itself costly, and these costs will be passed back to consumers. Sellers may well try to avoid performing their imposed obligations, thus requiring the additional expense of monitoring and enforcing seller performance. Problems of adverse selection or moral hazard may increase the likelihood of product failure among those covered by the PPR, thus raising the price consumers must pay for their protection (and raising the possibility of unintended redistributive consequences). Finally the imposition of a uniform PPR prevents consumers with diverse preferences from satisfying their individual demands, and restricts the flexibility of the market in responding to changes in demand and supply conditions.

APPENDIX A

SUMMARY OF INTERVENTION STRATEGIES

INFORMATION INTERVENTIONS

A. Increasing information about product risks

  1. Advantages

    a. Helps consumers appreciate the importance of PPR protection, thus remedying this information market failure.

    b. Preserves market flexibility, and allows each consumer to select his or her individually preferred level of PPR protection.

  2. Disadvantages

    a. Information may be costly to gather, or to communicate effectively.

    b. Information about product risk will (by itself) be insufficient if consumers lack information about the PPRs offered by sellers, or face significant enforcement costs.

B. Increasing information about available PPRs

  1. Advantages

    a. Encourages sellers to compete by offering more optimal PPRs, thus overcoming this market failure.

    b. Still preserves market flexibility, and allows individual consumers to select different levels of PPR protection.

  2. Disadvantages

    a. Information may be very difficult to summarize and effectively communicate to consumers.

    b. Information about PPR provisions will be insufficient (and possibly even misleading) if there are variations in the extent to which sellers perform their obligations, or in the quality of their performance.

C. Information about performance under PPRs

1. Advantages

   a. Encourages competition by sellers to improve their performance levels; helps correct the "enforcement costs" market failure.

   b. Preserves market flexibility and individual consumer choice.

2. Disadvantages

   a. Information may be both difficult to collect and difficult to summarize and effectively communicate to consumers.

ENFORCING PPR PERFORMANCE

A. Making sellers' obligations explicit in the contract

1. Advantages

   a. Informs consumers of their rights, which is a prerequisite to either consumer litigation or attempts to secure voluntary compliance.

   b. Gives consumers a stronger legal claim, in the event of litigation.

   c. Preserves market flexibility, by allowing sellers to choose what obligations to commit themselves to.

2. Disadvantages

   a. Contractual language will not alert consumers of their rights if consumers do not read their contracts.

   b. Consumers must still incur substantial costs either to litigate or to attempt to secure voluntary compliance.

   c. Requiring obligations to be explicit in the contract restricts flexibility somewhat, by precluding obligations (e.g., to perform "reasonably") whose scope will be contingent on unknowable future events and contingencies.

B. Promoting Consumer Dispute Resolution Mechanisms (CDRMs)

1. Advantages

   a. Reduces the cost to consumers of enforcing their rights, thus helping to correct the "enforcement costs" market failure.

   b. Preserves some flexibility, by still allowing sellers to choose what obligations to commit themselves to.

2. Disadvantages

   a. CDRMs are themselves costly to use, so the "enforcement costs" problem persist to some extent.

   b. CDRMs (by themselves) will not correct any information or other problems which lead sellers to offer suboptimal PPRs.

   c. Mandating a particular form of CDRM reduces market flexibility in developing some other, possibly more efficient, form.

MANDATING PPRs

A. Mandating Cooling-Off and Trial Periods

1. Advantages

   a. Frees consumers from having to make decisions in the presence of high-pressure sales tactics.

   b. Gives consumers time to comparison shop.

   c. (In the case of trial periods) Allows consumers to obtain information about product performance by actually experiencing the product for a short time.

   d. Reduces sellers' incentives to use high-pressure tactics, or to make misrepresentations which will be discovered during the cooling-off or trial period.

2. Disadvantages

   a. Administrative and increased selling costs.

   b. (In the case of trial periods) Depreciation of any products that are returned, by turning them into "used" goods.

c. Mandating the remedy reduces market flexibility and imposes the same solution on all consumers.

B. Mandating Warranties and Refunds

1. Advantages

a. Compensates consumers for product non-performance, thus satisfying their risk-aversion and (in some cases) promoting equitable values.

b. Gives sellers incentives to take cost-effective steps to reduce the likelihood of product non-performance, or to eliminate exaggerated or deceptive performance claims.

c. Corrects market failures leading to suboptimal PPR without the expense of collecting and communicating information to consumers.

2. Disadvantages

a. Performance is costly, and the costs will be passed back to consumers.

b. Eliminates market flexibility to offer diverse or more efficient PPRs, and requires continual readjustment as market conditions change.

c. Does not insure that the sellers will actually perform their obligations, unless additional steps to monitor performance are added.

d. May aggravate adverse selection and/or moral hazard problems.

e. May have unintended redistributive consequences.

APPENDIX B

PAST COMMISSION CASES AND RULES CONCERNING POST-PURCHASE REMEDIES

As shown in the Catalog (Section I), post-purchase remedies can be divided into three broad categories: information about post-purchase remedies; enforcement of post-purchase remedies; and required post-purchase remedies. The following chart lists representative cases and rules where the Commission has adopted each of these approaches.

1. INFORMATION ABOUT POST-PURCHASE REMEDIES

a. Information about risk associated with the product or service.

Amrep Corporation, 3 CCH Trade Regulation Reporter ¶21,600, Docket No. 9018 (July 18, 1979)(initial decision) Horizon Corporation, 3 CCH Trade Regulation Reporter ¶21,621, Docket No. 9017 (October 21, 1979)(initial decision)(must inform buyers of riskiness of land investment ventures).

Las Animas Ranch, Inc., [consent], Docket C-2877, 89 FTC 255 (April 22, 1977) Flagg Industries, Docket C-2903, 90 FTC 226 (September 27, 1977) (must disclose to prospective purchasers that investment of undeveloped land entails considerable risk)

Irving E. Miller [consent], */ Docket No. 9075 (Nov. 7, 1979) (must disclose the identity of those investment lots which are flood plane area prior to sale)

Idea Research and Development Inc., Docket No. 9032, 89 FTC 31 (January 11, 1979) (must disclose to prospective clients the past earnings of clients, the lack of legal protection afforded by their services, and advise the desirability of speaking with an attorney)

International Inventors, Inc., East, Docket C-2976 */ (July 5, 1979) (must disclose to prospective clients the company's success ratio in the placement of inventions).

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*/ Cases designated by a "C" preceeding the docket number and those where a specific notation exists were settled by consent order.

Raymond Lee Organization, Docket No. 9045, 92 FTC 489 (Nov. 1, 1978) (to prospective inventor/clients seeking organization's opinions of their products it must disclose the number of clients who have received money as a consequence of the company's service in excess of fees charged by the company)

Hair Replacements of Boston, Inc., Docket C-2819, 87 FTC 1260 (May 17, 1976) Creative Replacement, Inc., [consent] Docket No. 9020, 88 FTC 347 (September 8, 1976) (must disclose the pain inherent in a hair replacement process)

Samuel E. Womack, Docket C-2939, 92 FTC 924 (December 1, 1978) (must include in their advertising a statement that the purchase of trees and nursery stock by direct mail is inherently risky)

Hiken Furniture Company, Docket C-2923, 91 FTC 1115 (June 12, 1978) (company must prominently post in store sales areas copy of FTC order detailing, among other things, customers' alternatives and the company's obligations in the event furniture purchased from the company is deemed unsatisfactory; must furnish copy of news release setting forth order to all media used to advertise its products)

Driver Training Institute, Docket No. 9060 (July 27, 1978) (school must reveal the drop-out rate, the placement rate and salary range attained by its graduates)

b. Information about the contract's post-purchase remedies.

(1) Pre-sale

Magnuson-Moss Warranty-FTC Improvement Act, 16 CFR 702 (December 31, 1975) (require warranty terms of written warranties to be made available prior to sale)

George's Radio and Television Company, Inc., Docket No. 9115 (November 7, 1979) (must designate written warranties as full or limited and insure that they are available for consumer inspection)

Driver Training Institute, Docket No. 9060 (July 27, 1978) (school must reveal the drop-out rate, the placement rate and salary range attained by its graduates)

NU Dimensions International Ltd., Docket C-2318, 81 FTC 793 (November 20, 1972) (must inform prospective client of a weight reduction spa of the availability of a trial period prior to having the client sign a full contract)

Royal Furniture Company, Inc., [consent], Docket No. 9090, 93 FTC 422 (March 29, 1979) (must reveal on offered furniture sold without a warranty that it is provided "as is" and explain possibility of damage and lack of recourse)

(2) Post-sale

There are numerous Commission decisions mandating a post-purchase remedy. In virtually all of those cases the manufacturer or seller is required to provide buyers with information about the remedy. Therefore all of the cases within this category are also in one of the following categories. For this reason only a very few illustrative examples are given.

Cooling Off Period For Door To Door Sales, 16 CFR 429 (October 26, 1972) (sellers are required to provide buyers with a form notifying them of the three day cooling-off period for merchandise costing $25.00 or more sold door to door)

Raymond Lee Organization, Docket No. 9045, 92 FTC 489 (November 1, 1978) (must provide prospective inventor/ clients with information concerning 10 day cooling-off period upon organization's contracting to provide its opinion of inventors' products)

Australian Land Title Ltd., Docket C-2928, 92 FTC 362 (September 14, 1978) (must inform previous land purchasers of availability of partial refund)

Hertz Corporation, Docket C-2945, 92 FTC 980 (December 21, 1978) (must inform previous customers having credit balances of existence and amount of such balances)

Man Products, Inc., Docket C-2789, 87 FTC 217 (February 17, 1976) (must notify customers of opportunity to submit any disputes to binding arbitration)

Montgomery Ward & Company [consent], Docket C-3006 (January 24, 1980) (full page newspaper notices by company offering to reinstall or refund purchase price of wood-burning stoves which may be unsafe)

Royal Furniture Company, Inc. [consent], Docket No. 9090 (March 29, 1979) (in the event of an unsatisfactory resolution of a customer-seller dispute, seller is required to advise the customer of availability of small claims court option)

Skyline Corporation, Docket No. C-2642, 85 FTC 444 (March 4, 1975) (must inform previous purchasers of mobile homes of company's readiness to repair defects as previously promised in warranty)

Ford Motor Company [consent] Docket No. 9105 45 FR 13115 (February 28, 1980) (provisionally accepted order) (company must establish procedures to alert car owners as to existence of any post-warranty compensation programs)

Magnuson-Moss Warranty-FTC Improvement Act, 16 CFR 701 (December 31, 1979) (requires that means of implementing written warranty be specifically stated in warranty instructions)

2. ENFORCEMENT OF POST PURCHASE REMEDIES

a. Remedies that promote private enforcement

(1) By procedural measures

Insilco Corporation and Miles Homes Inc. Docket C-2919, 91 FTC 706, April 19, 1978 (company must establish complaint mechanism for handling consumer dissatisfaction with precut housing)

Skyline Corporation, Docket C-2642, 85 FTC 444 (March 4, 1975) (company must establish procedure for handling warranty repairs)

NU Dimensions International Ltd., Docket C-2318, 81 FTC 793 (November 20, 1972) (contains contract provision which preserves consumer's rights against holders of company's commercial paper)

Preservation of Consumers' Claims and Defenses [Holder Rule] 16 CFR 433 (1979) (allows consumers to maintain their claims and defenses against the holder of commercial paper on consumer products)

Kaufman and Broad, Inc., Docket C-2954, 93 FTC 235 (February 12, 1979) (requires availability of an arbitration mechanism for the resolution of disputes as to housing quality)

Walker-Thomas Furniture, Docket C-2775, 87 FTC 26 (January 6, 1976) (must establish arbitration system for handling consumer complaint regarding repair of damaged or defective furniture)

Josephs Furniture Company, Inc., Docket C-2599, 84 FTC 1310 (November 19, 1974) (consumer has option of submitting company/customer disputes to Better Business Bureau for binding arbitration at no cost to consumer.)

Great Western United Corporation, Docket C-2306, 81 FTC 661 (October 20, 1972) (requires arbitration of disputes concerning allegations of fraud or misrepresentation of land sales; all costs borne by the company unless consumer's claim is deemed frivolous by arbitrator in which case costs shall be split)

Royal Furniture Company [consent], Docket No. 9090, 93 FTC 422 (March 29, 1979) (must advise dissatisfied customers of the availability of small claims court option for the resolution of disputes)

Man Products, Inc., Docket C-2789, 87 FTC 217 (February 17, 1976) (company must notify customers of arbitration system available at no cost and at customers option; company will also remove contract provisions purportedly limiting jurisdictions in which customers can sue company or time periods in which suit must be commenced)

Labeling and Advertising of Home Insulation 16 CFR 460 (1980) (Requirement that sellers print the R-value of insulation rather than merely make oral representations)

(2) By defining performance standards

Use of Negative Option Plans By Sellers in Commerce 16 CFR 425 (1980) (customer must have at least 10 days to consider and accept or affirmatively reject purchase selection)

Mail Order Merchandise, 16 CFR 435 (1980) (option to cancel order and receive refund if merchandise is not delivered within 30 days or other specified period of time)

Auslander Decorator Furniture, Inc., Docket No. 8911, 83 FTC 1542 (April 23, 1974) (must deliver furniture within five days of date promised or provide buyer with an opportunity for a refund)

Guardian Loan Company, Docket C-2846, 88 FTC 632 (October 20, 1976) (mandated refunds must be provided within 30 days)

Idea Research and Development, Inc., Docket No. 9032, 89 FTC 31 (January 11, 1979) (company must provide all promised and necessary materials within 90 days)

Lindal Cedar Homes Inc., Docket C-2774, 87 FTC 8 (January 5, 1976) (seller of precut material for assembly of homes must replace defective materials within 45 days of complaint by customer)

National Meridian Services, Inc., [consent], Docket No. 9027, 89 FTC 192 (March 28, 1977) (requires that company respond to service request concerning basement waterproofing within seven days)

Royal Furniture Company, Inc., Docket No. 9090 93 FTC 422 (March 29, 1979) (company must investigate complaints within 14 days and repair, replace or refund merchandise within 31 days)

Skyline Corporation, Docket C-2642, 85 FTC 444 (March 4, 1975) ; The Commodore Corporation, Docket C-2643, 85 FTC 472, (March 4, 1975); Redman Industries Inc., Docket C-2640, 85 FTC 309 (March 3, 1975); Fleetwood Enterprise, Docket C-2641, 85 FTC 414 (March 4, 1975) (company must perform warranty repairs on all mobile homes which had defects that became evident during first year of ownership which owners notified company of within sixty days after company's notice that it must extend its warranty; requested warranty repairs on mobile homes subject to order must be performed within 30 days or within 3 days where safety or habitability is at issue)

b. Direct FTC Enforcement

Diners Club Inc., Docket No. C-2878, 89 FTC 298 (April 27, 1977) Carte Blanche Corp., Docket No. C-2879, 89 FTC 305 (April 27, 1977) Federated Department Stores, Docket No. C-2880, 89 FTC 313 (April 27, 1977) City Stores Inc., Docket No. C-2881, 89 FTC 322 (April 27, 1977) Atlantic Richfield, Docket No. C-2882, 89 FTC 330 (April 27, 1977); Hertz Corp., Docket No. C-2945, 89 FTC 980 (December 21, 1978) (consumers with credit balances on open-end charge accounts must be informed that those balances are refundable)

Ford Motor Company, Docket 9073 (September 21, 1979) and General Motors Corporation, Docket 9074 (February, 1980) (require company to return to former owners surplus proceeds derived from repossession of automobiles)

National Service Industries Inc., Docket C-2876, 89 FTC 222 (April 7, 1977) (refunds of part or all security deposits at termination of lease agreements for rented furniture)

Corning Glass Works, Docket C-2937, 92 FTC 861 (November 27, 1978) and Owens-Illinois Inc., Docket C-2938, 92 FTC 866 (November 27, 1978) (refunds to purchasers of three sizes of disposable glass culture tubes which had been short-packaged in the past)

Samuel E. Womack, Docket C-2939, 92 FTC 924 (December 1, 1978) (refund to mail order customers who purchased trees and nursery stock that was not received or that had died)

City Stores, Docket C-2910, 90 FTC 415 (November 1, 1977) (company must make refunds to customers of collection fees charged on delinquent accounts where those fees were not expressly provided for in the credit agreement)

Provider Benefit Company, Docket C-2911, 90 FTC 433 (November 8, 1977) (company ordered to offer refunds to individuals who had been charged credit life insurance as part of an installment product purchase whether they desired it or not)

CBS, Inc., Docket C-2896, 90 FTC 9 (July 21, 1977) (refunds and cancellation of delinquent accounts for unordered subscriptions; must inform customers that their credit rating has been restored and that they have a choice of refund or one year subscription to another magazine)

ITT Community Development Corp., Docket C-2854, 88 FTC 933 (December 10, 1976) (promised improvements in real estate tract developed for residential purposes must be made by 1982)

Flagg Industries Inc., Docket C-2903, 90 FTC 257 (September 27, 1977) (company must establish trust deposits for property owners to use for maintenance of common facilities of subdivision and make $4.1 million in physical improvements to property)

Art Instruction Schools, Inc., Docket C-2949, 93 FTC 32 (January 10, 1979) (partial tuition refunds to former vocational school students)

Driver Training Institute, Inc., Docket No. 9060, 92 FTC 235 (July 27, 1978) (pro rata tuition refunds to certain former tractor-trailer driving school students)

Main Street Furniture, Inc., [consent] Docket No. C-2772, 86 FTC 1588 (December 23, 1975); Hiken Furniture Company, Docket C-2923, 91 FTC 1115 (June 12, 1978) (customer may demand either full refund or repair [to be made in less than 3 weeks] or replacement [to be completed in less than 6 weeks] of damaged furniture)

Australian Land Title Ltd., Docket C-2928, 92 FTC 362 (September 14, 1978) (partial refund of payments for all purchasers and defaulters of encumbered land; company ordered to stop collecting outstanding contract payments)

Airco [consent], Docket No. 9098 (July 31, 1979) (company must allow customers to submit dispute to arbitration and it may not cut off their supply of industrial gas while arbitration is taking place)

Skyline Corporation, Docket C-2642, 85 FTC 444 (March 4, 1975); The Commodore Corporation, Docket C-2643, 85 FTC 472, (March 4, 1975); Redman Industries Inc., Docket C-2640, 85 FTC 309 (March 3, 1975); Fleetwood Enterprise, Docket C-2641, 85 FTC 414 (March 4, 1975) (company must perform warranty repairs on all mobile homes which had defects that became evident during first year of ownership which owners notified company of within sixty days after company's notice that it must extend its warranty)

Madison Mobile-Modular Homes, Inc., Docket C-2973, 93 FTC 1068 (June 21, 1979) (company which illegally disclaimed implied warranty must inform home owners that they are entitled to additional warranty protection)

Arnaudville Industries, Inc., Docket C-2972, 93 FTC 1061 (June 12, 1979) (company must remedy its confusing offer of a "full one year limited warranty" by treating it as if it were a one year full warranty)

Kaufman and Broad, Inc., Docket C-2094, 93 FTC 235 (February 12, 1979) (must provide a warranty covering major housing construction defects for four year, major systems for two years, and materials and workmanship for one year or a HOW warranty, at company's option)

Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 CFR 436 (1979) (requires franchisers to return all deposits as specified in the contract)

REQUIRED POST-PURCHASE REMEDIES

a. Cooling-off

National Housewares Inc., Docket No. 8733, 90 FTC 512 (November 18, 1977); Emdeko International Inc., Docket No. 8973, 90 FTC 512 (November 18, 1977) (cooling-off period for packaged sales of merchandise where initial sales contact were made by telephone or direct mail)

Cooling-Off Period For Door-to-Door Sales, 16 CFR 429 (1980) (three day cooling-off period for merchandise costing $25.00 or more sold door-to-door)

Irving E. Miller [consent], Docket 9075 (November 7, 1979) (three day cooling-off period following company guided tour of investment land)

Insilco Corporation and Miles Homes, Inc., Docket C-2919, 91 FTC 706 (April 19, 1978) (three day cooling-off period on the purchase of pre-cut housing)

Mainstreet Furniture, Docket C-2772, 86 FTC 1588 (December 23, 1975) (three day cooling-off period on the sale of furniture)

Ryder Systems Inc., Docket C-2915, 90 FTC 921 (December 28, 1977) (three day cooling-off period for vocational school students)

Hair Replacements of Boston, Inc., Docket C-2819, 87 FTC 1260 (May 17, 1976) (three day cooling-off period on hair replacement process)

Creative Replacements Inc., [consent] Docket No. 9020, 88 FTC 347 (September 8, 1976) (7 day cooling-off period on hair replacement products)

Driver Training Institute, Docket No. 9060, 92 FTC 234 (July 27, 1978) (7 day cooling-off period for vocational school students)

Mayday Company, Inc., Docket C-2866, 88 FTC 775 (1976); Jetma Technical Institute [consent], Docket No. 9061, 90 FTC 285 (October 19, 1977) (ten day cooling-off period for vocational school students)

Horizon Corporation, 3 CCH Trade Regulation Reporter ¶21,621, Docket No. 9017 (October 21, 1979) (initial decision) (ten day cooling-off period following purchase of investment property; where property is sold sight unseen, company shall provide buyer up to one year in which to visit property and demand a refund if dissatisfied)

Lafayette United Corp., [consent], Docket No. 8963, 88 FTC 683) (October 26, 1976) (12 day cooling-off period to vocational school students)

Proprietary Vocational and Home Study Schools, 16 CFR 438 (1980) (14 day cooling-off period for vocational school students; pro-rata refund for withdrawing students)

Universal Electronic Corporation, Docket No. 8815, 78 FTC 265 (January 28, 1971) (three day cooling-off period to cancel vending machine contracts; provide cancellation right for customers whose vending machines are not moved to satisfactory locations)

Idea Research and Development Inc. [consent], Docket No. 9032, 89 FTC 31 (January 11, 1977) (company may not accept fees from persons seeking its invention promotion service except as a percentage of royalty or gain from successful marketing of the product; 10 day cooling-off period)

Arthur Murray Studio of Washington, Inc. [consent] 3 CCH Trade Regulation Reporter ¶19529 (February 23, 1971) affirmed Arthur Murray Studio of Washington, Inc. v. FTC, 458 F.2d 622 (5th Cir. 1972) (company may not make contracts for more than $1500; must provide seven day cooling-off period for students purchasing contracts)

b. Refunds

Windsor Distributing Company, Docket No. 8773, 77 FTC 204 (1970), affirmed 437 F.2d 443 (3rd Cir. 1971) (right to cancel contract if seller of vending routes failed to place machines in locations satisfactory to purchasers)

Auslander Decorator Furniture, Docket 8911, 83 FTC 1542 (April 23, 1974) (company must deliver furniture within five days of promised date or provide buyer opportunity for refund)

c. Trial period

NU Dimensions International Ltd., Docket C-2318, 81 FTC 793 (November 20, 1972) (pro rata refunds to weight reduction spa patrons who 1) cannot continue program for doctor-certified reasons; 2) cannot continue program because they move more than 25 miles from the salon; salon must provide two day trial period with a pro rata refund and cancellation fee of no more than $15 or 10% of the contract price, whichever is less, on all new memberships selling for more than $25.

d. Warranty

Fedders Corporation, Docket C-2971, 93 FTC 949 (June 14, 1979) (company will extend full warranty for one year on component subject to abnormally high failure rate)

Lindal Cedar Homes, Inc., Docket C-2774, 87 FTC 8 January 5, 1976) (seller of precut materials to assemble homes must provide a warranty against material defects of no less than 150 days from date of receipt)

Renault U.S.A., Inc., Docket C-2960, 93 FTC 553 (April 26, 1979) (company must remedy illegal disclaimer of implied warranty on drivetrain by reforming duration of warranty coverage and notifying buyer that implied warranty extends for up to four years)

Montgomery Ward & Company [consent], Docket C-3006 (January 24, 1980) (company must offer to reinstall or provide refund for wood-burning stores installed in homes according to improper instructions)

APPENDIX C

STATE LAW INTERVENTIONS REGARDING PPRs

It is often impossible to assess with great accuracy the potential costs and benefits of proposed interventions. In many cases the best assessment must be based on assumptions, or on only a recognition of the kinds of costs and benefits that might be expected. However, where a state's law makes any such intervention, the policymaker has the opportunity to gather empirical data to make these assessments.

The following compilation of state statutes follows the same outline as Section I of this book in sorting the different kinds of legal interventions in the market for PPRs.

A. INFORMATION

1. Information About Product/Service Risks

Most PPRs include some informational element. The following acts have a major disclosure requirement, designed to help the consumer evaluate the risks or to allocate the risks between buyer and seller. All are directly linked with enforcement provisions. Statutes requiring only an itemization of costs or other contract terms are discussed below (Section D).

Arizona: Life care contracts. Life care provider must deliver to buyer a copy of its application for certification or its latest annual report, whichever is more recent, before contract is executed or initial payment made; both include information on provider's financial status, past record, and cancellation terms. Seven-day cooling-off period cannot begin until report or application delivered. Ariz. Rev. Stat. Ann. §§ 20-1801-1811.

California: Contracts for discount buying services. Pre-contract disclosure of list of 100 currently available items that reasonably represent the type of goods sold. In the event of discontinuance of goods disclosed, buyer has option of cancelling contract and receiving pro-rata refund, if contract signed within past six months. Disclosures of incidental charges and policy towards warranties, cancellation of orders, return of goods and refunds also required. Non-complying contracts and those entered into following misrepresentation by seller are voidable. Cal. Civ. Code §§ 1812.100-128 (West).

Florida: Invention development service contract. Both contract and initial contact must disclose total number of customers and number of customers who have received from the invention development services more than they paid. Statements that developer cannot provide patent or copyright protection and developer does not intend to spend more than the fee or, if he does, estimate of expenditures beyond fee. (Contract voidable by customer for failure to make disclosures; person injured by violation or by fraudulent representation may sue for greater of $3,000 or treble damages plus reasonable attorney's fees.) Fla. Stat. Ann. § 501.136 (West).

Illinois: Business and vocational schools. Any school offering placement service must disclose, at time of agreement, percentage of students receiving bona fide job offers (Private right of action for injury; actual damages plus attorney's fees and costs may be awarded.) Ill. Rev. Stat. ch. 144, §§ 136-162.

Maine: Used cars. Extensive disclosure requirements concerning past history, and current condition of car. Dealer must provide written warranty that car complies with statutory standards and statement of what dealer will do in case of mechanical failure and at whose expense. (Private action for breach of warranty or unfair trade practice.) Me. Rev. Stat. Ann. tit. 10, §§ 1471-1477.

Michigan: Living Care Disclosure Act. Broad disclosures include identity, and corporate or other affiliation of the facility; identity of persons affiliated with facility, and any past convictions for fraud, embezzlement, etc.; financial status; services provided; and contract terms. (Enforcement primarily by the state, but private actions not precluded and action for fraud or misrepresentation created.) Mich. Comp. Law Ann. §§ 554.801-.844.

Minnesota: Condominums. Vendor must make disclosure about contract terms, financing, owners' association, floor plans, warranties, etc., at least 15 days before each unit is conveyed to first purchaser. (Purchaser may rescind within five days of receiving disclosure and obtain complete refund; right to rescind waived if buyer proceeds to closing without receiving disclosure.) Minn. Stat. Ann. § 515.215 (West).

Invention services. In both contract and initial contact, disclosure of number of customers and number who received returns greater than the fee, and statement that developer who is not lawyer cannot give legal advice about copyright, trademark and patent law. Pre-contract disclosure of median fee charged during past six months. Contract must explain right to inspect any records or correspondence, upon seven days, written notice. Failure to make disclosures required prior to contract renders contract voidable by customer. (Civil action for injury from any failure to disclose or misrepresentation; treble damages or $2,500, whichever is greater, and reasonable attorney's fees and costs may be awarded.) Id. §§ 325A.01-.10.

New York: Solar Energy Products Warranty Act. Contracts for installation must state names and addresses of manufacturers of component parts costing more than $25. Information on performance standards included in contract, and disclaimer of warranty clearly and conspicuously displayed. (Private party may seek injunction and actual damages, plus attorney's fees and costs, if no action has already been commenced by the attorney general.) N.Y. Energy Law §§ 12-101 to -114 (McKinney).

The right to obtain a written estimate before repairs are made by service facilities is another informational remedy. Notice must be posted conspicuously to inform customer of the right to request an estimate. The buyer need not pay for any work costing more than 10 percent above the original estimate. Examples include:

Connecticut: Applies to all consumer goods except motor vehicles; excludes repairs costing less than $25. Conn. Gen. Stat. §§ 42-110r to v.

New Hampshire: Applies to motor vehicles only. N.H. Rev. Stat. Ann. §§ 358-D:1 to :12.

2. Information about the Contract's PPRs

a. Pre-sale disclosures

Most statutes giving consumers the right to cancel or rescind contracts require that notice of the right be given in some form. Every state but Georgia requires door-to-door salesmen to notify customers of the right to cancel during the cooling-off period. In most states, specified language must be included in the contract, and often notice must be given orally, as well.

All of the statutes that give the buyer a right to cancel a contract beyond an initial cooling-off period require that the seller inform the buyer of this right, and most contracts must set out the conditions upon which refunds are granted. (See Section (B)(3) below.)

Statutes prescribing express warranties for a particular type of product, such as mobile homes, normally require that the manufacturer's or dealer's name and address be set out in the warranty agreement.

Two examples of notice requirements that facilitate obtaining fulfillment of warranty or contract agreements are:

California: Dance studio contracts. Contract must state that the studio has a surety bond and information about it can be obtained from the Secretary of State at a given address. Bond to be used for redress of consumers injured by fraud or dishonesty, or failure to provide services (see Section (B)(1)(a) below for discussion of bonding.) Cal. Civil Code §§ 1812.50-.68.

Oregon: Sale of consumer goods. Retailers and manufacturers must supply information about where servicing and repairs under warranty can be obtained. Or. Rev. Stat. §§ 77.8010-.8200.

B. ENFORCEMENT

1. Promoting Private Enforcement

a. Procedural measures

The first four types of procedural measures assist consumers in obtaining post-purchase relief through existing channels. The final category--arbitration--creates a new channel not otherwise available to the consumer.

(i) Require repair facilities within the state

California, Oregon and Rhode Island require manufacturers that make express warranties to maintain adequate repair facilities within the state or authorize retailers or dealers to make warranty repairs. Washington only allows manufacturers to limit consumer remedies to repair or replacement if facilities maintained within the state are adequate to provide reasonable and expeditious performance of warranty obligations (without setting specific standards). Cal. Civil Code §§ 1790-1795.7 (Song-Beverly Consumer Warranty Act); Or. Rev. Stat. §§ 72.8010-.8200; R.I. Gen. Laws § 6A-2-329; Wash. Rev. Code Ann. § 62A.2-316.

(ii) Make manufacturer liable for dealer repairs

Laws stipulating that manufacturers reasonably compensate authorized dealers or retailers for repair work under manufacturers' warranties are primarily intended to protect dealers. Consumers also benefit, however, for a dealer who knows he or she will be adequately reimbursed is more likely to perform warranty work properly. Under these laws, reasonable compensation for labor and parts is considered to be the rate charged retail customers for work not under warranty, either by the dealer in question or other dealers in the community.

Many dealer compensation laws state that a manufacturer shall fulfill its warranty obligations, clearly placing liability for breach of warranty on the manufacturer. One state makes the purchaser of a mobile home a third-party beneficiary of agreements between dealers and manufacturers, that set out their respective liabilities for warranty and delivery and preparation work. Colo. Rev. Stat. §§ 12-51.5-101 to -124.

Seven states also require the manufacturer to compensate the dealer for legal expenses incurred by the dealer in actions brought by consumers and arising from manufacturing or design defects.

In 18 states, compensation laws apply only to motor vehicle manufacturers and dealers; only mobile homes are covered in two others, Colorado and Florida. Id.; Fla. Stat. Ann. §§ 320.834-.839 (West). The Minnesota compensation provision applies to all consumer goods. Minn. Stat. Ann. §§ 325.951-.954. All consumer goods are also covered by the three statutes, cited above, that require manufacturers to maintain repair facilities within the state or authorize dealers to make repairs. If the latter option is chosen, manufacturers must reasonably compensate dealers. */

Examples of motor vehicle dealer compensation statutes are:

Kansas: Manufacturers may not require unreasonable proof to establish reasonable rate of compensation. Kan Stat. Ann. § 8-2317.

New Hampshire: Reimbursement of legal fees and claims for alleged or actual defects, not arising from dealer's negligence. N.H. Rev. Stat. Ann. § 357-B:9a.

Utah: Thirty days to approve or give reason for disapproving dealers' claims. Thirty days from approval to pay claims. Utah Code Ann. § 13-14-10.

(iii) Surety bonds and escrow

Thirteen states use surety bonds or escrow requirements as a means to protect consumers from fraudulent practices, failure to provide services, failure to fulfill warranty obligations, and so forth. They often ensure that a buyer's right to cancel is meaningful. The following examples demonstrate the range of application of these two instruments of consumer protection:

Arizona: Life care contracts. Entrance fees of new resident placed in escrow until facility is made available. Escrow fund with amount due on mortgage and other long-term financing during next 12 months must be maintained at all times. Ariz. Rev. Stat. Ann. §§ 20-1801 to-1811.

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*/ California's Song-Beverly Act also includes a mobile home warranty that provides for dealer compensation. Cal. Civil Code §§ 1797-1797.5.

Colorado: Mobile home dealers. Dealers must post surety bond ranging from $10,000 to $25,000, depending on annual gross sales in state; salesmen must post $5,000 bond. For benefit of any person injured by fraud, failure to fulfill warranty obligations and other violations. Colo. Rev. Stat. §§ 12-51.5-101 to-128.

Florida: Health studio contracts. Surety bond of $10,000 posted by health studios, planned or under construction; for benefit of persons injured by violations of act, including cooling-off period, cancellation and refund provisions. Fla. Stat. Ann. § 501.012 (West).

Home warranty association bonds. Surety bond, deposit of securities with state, or letter of credit for $100,000; for those sustaining actionable injury due to failure to perform warranty obligations. *Id.* § 634.305.

Life care contracts. Initial payments remain in escrow during seven-day cooling-off period. *Id.* § 651.055. See also, Mich. Comp. Laws Ann. §§ 554.806-.844 (same).

Maryland: Motor vehicle. Manufacturer or distributor must post surety bond based on new car sales in state during previous year, ranging from $25,000 for 1 to 50 cars to $300,000 for over 10,000 cars. Right of action against bond for anyone injured by breach of express or implied warranty, including state agency, dealer, buyer, or member of the public. Md. Transp. §§ 15-103, 15-205, 15-213. See also, N.H. Rev. Stat. Ann. §§ 407-A:3-a to -c (bond not less than $50,000).

Minnesota: Invention services. Must maintain bond of 10 percent of gross income in the state during past year or $25,000, whichever is greater; for benefit of those injured by fraud, cessation of business or intentional violation of act. Minn. Stat. Ann. §§ 325A.01-.10.

(iv) Records maintained by seller.

Requiring sellers to maintain records preserves evidence that may be crucial in disputes with buyers. The period during which records must be maintained is fixed by law, varying from one to five years. Cancellation notices, warranty agreements and complaints, other correspondence with the consumer and correspondence on behalf of the consumer are the most common records sellers must maintain.

The potential legal utility of this type of requirement is illustrated by a California law allowing a consumer to request that the seller rescind a home solicitation sales contract entered into upon misrepresentation by the solicitor. The consumer can only collect damages of double the selling price if he first requested termination and the seller refused. The law provides that the seller must maintain copies of all demands for termination for one year. Failure to do so creates a presumption affecting the burden of proof that the demand was properly made. Cal. Bus. & Prof. Code § 7500.3.

Other examples of record-keeping requirements include:

Florida: Invention development service contracts. All records and correspondence relating to performance of the contract must be maintained for three years after expiration of the contract. Records may be inspected by buyer upon seven days' notice. Fla. State. Ann. § 501.136 (West). See also, Minn. Stat. Ann. §§ 325A.01-.10 (West)(same).

Minnesota: Truth in repairs. Records of repairs authorized, repair estimates, invoices, etc. must be kept for one year. (Consumer need not pay for unauthorized work or charges more than 10 percent above estimate.) *Id.* § 325.968.

Nebraska: Motor vehicle sales. Sales agreement, including specification of warranty terms, must be maintained for five years. Neb. Rev. Stat. § 60.1417.

New Hampshire: Hearing aids. Sales receipt and any correspondence must be kept for three years. (Law provides for 30-day trial period.) N.H. Rev. Stat. Ann. §§ 137-5:1 to :20.

New Jersey: Door to door sales. Record of buyer's notice of cancellation must be kept 18 months. N.J. Rev. Stat. Ann. §§ 17:16C61.1-.9 (West).

(v) Arbitration

Only two states have provided for arbitration as a means of settling a particular type of consumer dispute, as opposed to consumer dispute resolution mechanisms generally available under the Magnuson-Moss Warranty Act or similar state enactments. Under the New Jersey new home warranty law, builders are required to establish a security fund, to cover consumer claims for defects under warranty. Before any money can be awarded from the fund, the claim must be reviewed through a conciliation or arbitration procedure by the housing department. An award from the fund will be made if the claim by the owner is found to be justified and the builder refuses to correct the problem. N.J. Rev. Stat. Ann. §§ 46:3B1-:3B12 (West).

The Michigan Living Care Disclosure Act also creates an arbitration procedure, but submission of disputes to arbitration is not mandatory. A dispute between a resident and the life care facility "shall upon election and written consent of the parties be submitted to [binding] arbitration." Mich. Comp. Laws Ann. § 554.811.

b. Private rights of action

Every state but Alabama has enacted legislation similar to the FTC Act. In 41 states, Puerto Rico and the District of Columbia, consumers have a private right of action against unfair or deceptive trade practices; class actions may be brought in 19 states. Damages awarded may be actual damages, double or treble damages, punitive damages or a fixed or minimum award, typically of $100 or $200. Attorney's fees and costs usually may be awarded to successful plaintiffs.

Many of the statutes governing particular types of transactions define violations as unfair or deceptive trade practices, placing them within the scope of the "little FTC act". Others provide for separate rights of action and damages. Almost all provide for discretionary award of reasonable attorney's fees and costs, in addition to other damages. Generally, these statutes state that remedies provided therein are cumulative, not exclusive.

Some statutes that prescribe unusual remedies are:

California: Song-Beverly Consumer Warranty Act. Buyer of consumer good injured by willful violation of statute, implied or express warranty, or service contract may sue for treble damages and other legal or equitable relief; prevailing plaintiff may be awarded aggregate costs and expenses, including attorney's fees based on actual time expended. Cal. Civil. Code §§ 1790-1797.5.

Connecticut: Health club contracts. Buyer of contract that is in "material violation" of statute has right to cancel and right to sue for three times the amount actually paid under the contract plus reasonable attorney's fees. Conn. Gen. Stat. §§ 19-341a to-341j.

Florida: Invention development services contract. Anyone injured by violation of statute, fraudulent representation, or failure to make required disclosures may bring action for $3,000 or three times the amount of actual damages, if any, whichever is greater; court may award reasonable attorney's fees. Any person affected by a violation may bring an action for injunction. Fla. Stat. Ann. § 501.136 (West).

Kentucky: Mobile home "lemons" act. If owner timely notifies manufacturer that mobile home unmerchantable and manufacturer refuses to replace it, owner may bring action to recover price paid less diminution in value due to abuse by owner or third person; a prevailing owner may be awarded attorney's fees. Ky. Rev. Stat. Ann. §§ 367.710 to .775 (Baldwin).

Massachusetts: Hearing aid sales. Provisions governing sales include hearing test prior to sale, written receipt with breakdown of costs, and record maintenance for four-year period; violation gives rise to private right of action as unfair trade practice. Mass. Gen. Laws Ann. ch. 93, §§ 71-75 (West).

Minnesota: Club contracts. Contract that does not contain required notice of right to cancel may be cancelled at any time. Minn. Stat. Ann. §§ 325.96-.965 (West). (Similar provisions are cited under section (a)(1) above and section (c)(1) below.)

Ohio: Prepaid entertainment contracts. If seller refuses to refund payments made by buyer after cancellation, buyer may sue for double the amount due him, plus reasonable attorney's fees. Ohio Rev. Code Ann. §§ 1345.41-.50 (Page).

2. Direct Government Enforcement

Most consumer protection laws are enforced by the attorney general or other state officials, either solely or together with private parties. As with private rights of actions, governmental authority to enforce consumer protection laws may arise under "little FTC acts" or other legislation. State officials usually may seek injunctions of violations, and often civil or criminal fines. Many statutes make violations a misdemeanor; imprisonment is occassionally permitted.

Almost all "little FTC acts" allow state officials to obtain restitution for aggrieved consumers. The Maine unfair trade practices act demonstrates the direct benefits actions by the attorney general may have for consumers. First, the attorney general may seek restitution for consumers directly. Second, the attorney general may seek an injunction. A permanent injunction or similar court order serves as *prima facie* evidence of an unlawful practice in an action brought by a consumer, facilitating private actions for redress. Me. Rev. Stat. Ann. ch. 5 §§ 209, 210, 213.

C. REQUIRED PPRs

1. Cooling-Off Periods

a. Door-to-door sales acts

Every state has a home solicitation or door-to-door sales act. The standard act is similar to the FTC door-to-door sales rule (16 CFR 429 (1980)) and provides for a three-day cooling-off period. Most home solicitation acts cover transactions with a minimum purchase price of $25; a few states have no minimum price. Both goods and services are included in most statutes, though a few states exclude services. The statutes of those states that adopted a home solicitation sales act as part of the Uniform Consumer Credit Code usually cover credit sales only. The most typical exclusions from door-to-door sales acts are sales and rentals of farm machinery and equipment, and transactions governed by other state and federal regulation, such as insurance sales, real estate transactions and sales of securities and commodities by registered brokers.

The seller must refund all payments within 10 days of receipt of cancellation, except in Maine and New Hampshire, where a 15 or 20 day period applies and Alaska and Indiana, where no time is set. In all but three states, the seller must repossess goods already delivered within 20 or 40 days of cancellation. In Indiana, however, the buyer must return the goods to the seller, and in Alaska and New Hampshire, the seller may require the buyer to return the goods at the seller's expense.

The following states include novel provisions in their door-to-door sales acts:

Alaska: Five-day cooling-off period. Alaska Stat. § 45.05.125.

Arkansas: Cooling-off period begins to run when actual notice given; if seller fails to give notice, buyer no longer obliged to return goods in substantially same condition. Ark. Stat. Ann. §§ 70-914 to -924.

Georgia: Buyer may recover minimum of $100 and attorney's fees for willful violation by seller. Ga. Code Ann. §§ 96-901 to -913.

Hawaii: Act covers advertisements offering gift, prize, premiums, stamps, coupons, etc. to induce consumer to place of business, no matter where contract signed. Contract unenforceable by seller if seller violates any provision. Hawaii Rev. Stat. § 481C.

Indiana: Two-day cooling-off period; no statutorily required time by which refund must be made for non-credit sales. Ind. Code Ann. § 24-5-6-1 (Burns). (Credit sales covered by U.C.C.C. provision. Id. § 24-4.5-2-501 to -505.)

Iowa: Contract or evidence of indebtedness cannot be assigned within seven days, cancellation under cooling-off provision is complete defense against both sellers and assignees. Iowa Code Ann. §§ 82.1-.6 (West).

Maine: Fifteen days to refund for non-credit sales. Me. Rev. Stat. Ann. tit. 32, §§ 4661-4670. Twenty days to refund for credit sales. Id. tit. 9A, §§ 3.501-.507.

Maryland: Buyer may cancel at any time if seller violates provisions. Violations include failure to disclose immediately one's identity and purpose and using ruse or misrepresentation. Md. Com. Law Code Ann. §§ 14-301 to -306.

Michigan: No person may bring action for collection of contract without proving compliance with act, i.e., burden of proof is on seller. Any refunds or penalties owned to debtor may be raised as defense or set-off. Mich. Comp. Laws Ann. §§ 445.111 -.117.

Minnesota: Private right of action for damages, costs and reasonable attorney's fees; violation is unfair trade practice, and attorney general can also seek consumer redress. Minn. Stat. Ann. §§ 325.933 -.938 (West).

New Hampshire: During 15 days following receipt of cancellation, buyer and seller may mutually agree to negotiate for repair, replacement, substitution or a credit allowance. Right to cancel remains in effect during negotiations. If no negotiations, seller must refund within 15 days. Goods only become property of buyer if seller makes no effort to repossess within 90 days. N.H. Rev. Stat. Ann. § 361-B:1 to :3.

New York: Buyer may recover amount due plus $100 and reasonable attorney's fees and court costs, if seller refuses to refund within 10 days. No assignment of indebtedness within 10 days. No assignment of indebtedness within five days after purchase; assignee subject to all claims and defenses of buyer against seller-assignee, including set-offs. N.Y. Pers. Prop. §§ 425-431 (McKinney).

North Carolina: Buyer may rescind contract and receive full refund if goods or services not provided within 30 days, unless longer period agreed upon in writing. N.C. Gen. Stat. §§ 25A-38 to -42.

Tennessee: Cooling-off period extended to 30 days if seller fails to immediately identify himself and his purpose or is guilty of misrepresentation. Tenn. Code Ann. §§ 47-16-101 to -107. See also Va. Code §§ 59.1-21.2 to .7 (same).

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b. *Contracts for services*

Cooling-off periods are frequently included among provisions designed to protect consumers from unfair practices in certain service industries. The following acts, (some of which are also cited in Section D, below) contain cooling-off periods:

California: *Contracts for discount buying services*. Three-day cooling-off period; complete refund. Notice of right to cancel must comply with home solicitation sales law. Cal. Civil Code §§ 1812.100-.128.

Florida: *Contracts for health studios*. Three-day cooling-off period; complete or pro-rata refund. Fla. Stat. Ann. § 501.012 (West). *Life care contracts*. Seven days to rescind without penalty, during which time down payment kept in escrow. Id. § 651.055

Invention development services contracts. Seven-day period in which either invention developer or customer may cancel contract; full refund of materials and moneys paid within five days. *Id.* § 501.136.

Illinois: *Business and vocational schools*. Six day cooling-off period. Ill. Rev. Stat. §§ 144-136 to 162.

Louisiana: *Dance studios*. Three-day cooling-off period. Non-complying contracts or contract entered into upon fraudulent or misleading information are void and unenforceable. La. Rev. Stat. Ann. §§ 51:1554-:1566 (West).

Michigan: *Living care disclosure act*. Right to rescind purchase of life lease or long-term lease within seven days, during which funds kept in escrow. Mich. Comp. Laws Ann. §§ 554.801 to .844.

Minnesota: *Club contracts*. Three-day cooling-off period; contract may be cancelled at any time if required notice not included. Minn. Stat. Ann. §§ 325.96-:965 (West). *Invention services*. Three-day cooling-off period; full refund within 10 days. *Id.* §§ 325A.01-.10.

New Hampshire: *Private trade, commercial and correspondence schools*. Contracts purporting to bind buyer to pay schools for training are subject to provisions of home solicitation sales law. (See above.) N.H. Rev. Stat. Ann. §§ 188-C:1 to:9.

Home repairs. Three-day cooling-off period applies to all solicited contracts for home repairs and improvements or for installation of siding on any building. Id. §§ 320:1-:2.

New York: Health club services. Three-day cooling-off period; full refund within 15 days; assignees must honor right to cancel. N.Y. Gen. Bus. Law §§ 620-634.

Other cooling-off provisions:

Florida: Retail sales establishments. Unless retail sellers post "no refund" signs, consumer may return unused merchandise within seven days and obtain full refund; food and other perishables and custom-made goods excluded. Id. § 501.142. Crated items. Right to cancel signed statement of satisfaction and to return goods delivered in box or crate within five days of delivery; signed statement of satisfaction not containing notice of right to cancel is null and void. Fla. Stat. Ann. § 501.141 (West).

Minnesota: Condominiums. Buyer has unconditional right to rescind within five days of receipt of statutorily required disclosure; right waived if buyer proceeds to closing without receiving disclosure. Minn. Stat. Ann. § 515.215 (West).

2. Trial periods

New York: Hearing aid sales. Every new or reconditioned hearing aide must be accompanied by thirty day money-back guarantee. Miximum cancellation fee of lesser of 10 percent or $30 (adjusted with consumer price index); additional charge for ear mold or batteries, not to exceed regular retail price or twice actual cost to seller. N.Y. Gen. Bus. Law § 784. See also, Conn. Gen. Stat. § 20-402a (12 percent cancellation fee); N.H. Rev. Stat. Ann. §§ 137-5:1 to :20 (20 percent cancellation fee).

Ohio: Prepaid entertainment contract. Buyer may cancel contract within three days of receiving first service or within seven days of signing contract, whichever is earlier; if facility or service not available when contract signed, buyer has seven days to cancel after first service. Maximum cancellation fee of $10. Applies to dance studios, social referral services, martial arts training and health spas. Ohio Rev. Code Ann. §§ 1345.41-.50 (Page).

3. Cancellation and Refund Formulas

The statutes in this category allow cancellation of contracts for services beyond an initial cooling-off or trial period. Under seven of these laws, the right to cancel is triggered by the inability of the seller to provide the services as agreed or the inability of the buyer to take advantage of the services, because of death, disability or relocation. The remaining six statutes permit the buyer to cancel at any time, though advance notice may be necessary. All but two of these statutes prescribe how refunds are to be calculated. The two that do not define the refund formula are:

Florida: Life care contracts. Agreement may be cancelled by either the member or the provider upon 30 days' notice. Terms governing refund must be clearly set out in contract. Automatic cancellation and full refund if member dies before occupying facility. Fla. Stat. Ann. § 651.055 (West).

West Virginia: Correspondence courses and multiple magazine subscriptions. Buyer has right to cancel at any time. Cancellation immediately relieves buyer of obligations for services not received, return of course materials cancels indebtedness for correspondence courses. W. Va. Code § 46A-2-138.

Statutes that provide refund forumulas are:

California: Discount buying services. Buyer may rescind contract and obtain pro rata refund if: (a) the organization relocates more than 20 miles farther from buyer's residence, (b) it discontinues a category of goods or services listed as available at time buyer signed contract, if signed within last six months, or (c) contract is transferred to another organization that will provide substantially fewer goods and services, and buyer did not give written consent after full disclosure. Cal. Civil Code §§ 1812.100 -.128.

Dance studios. Cancellation at any time. If contract cancelled within 180 days, complete refund less charge for lessons taken. If cancelled after 180 days, seller may retain additional cancellation fee of 10 percent of the unpaid balance. Refund within 10 days. Pro-rata refund in the event of death or disability. *Id.* §§ 1812.80-.96.

Connecticut: Health clubs. Right to cancel if buyer relocates more than 25 miles from a facility operated by seller, or one that would assume the contract. Buyer may be relieved of liability during period of physical disability or have contract extended; contract suspended if buyer asked to undergo examination or prove disability. Contract cancelled by death. Pro-rata refund within 15 days of cancellation. Conn. Gen. Stat. §§ 19-341a to -341j.

Florida: Health studios. Right to cancel and receive pro-rata refund if seller ceases to do business or relocates more than five miles away, or if buyer dies or becomes totally and permanently disabled. Fla. Stat. Ann. § 501.012 (West).

Louisiana: Dance studios. Pro-rata refund for lessons not completed due to death or disability. If payment in installments, refund of finance charge according to "sum of balances method". La. Rev. Stat. Ann. §§ 51:1554-:1566 (West).

Massachusetts: Personal services. Cancellation at any time; termination from day notice mailed. Pro-rata refund less "actual reasonable administrative costs", as itemized in the contract; administrative fee may not exceed lesser of 5 percent of contract price or $50. Applies to trade schools, correspondence schools, dance studios and other proprietary schools. Mass. Gen. Laws Ann. ch. 255, § 13K.

Michigan: Living care contracts. Resident may cancel contract upon 30 days notice subsequently. If notice given within first 30 days, refund of all but actual costs of care and refurbishing unit for resale. After first 30 days, facility may retain either per capita or actual costs of care, actual cost of refurbishing unit for resale, and 10 percent of the entrance fee up to the first $15,000. Mich. Comp. Laws Ann. §§ 554.801-.844.

New York: Correspondence courses. Cancellation at any time, either through actual notice or constructive notice (failure to attend consecutive classes constituting 25 percent of lessons or contract time). Seller may retain payment proportional to services used plus cancellation fee up to 5 percent of contract price, but no greater than $50. Refund within 10 days. N.Y. Pers. Prop. Law § 412-a (McKinney).

Health clubs. Membership may be canceled if buyer dies, if he or she cannot receive services because of "significant physical disability" for over six months, or buyer moves more than 25 miles from health club. Refund must be made within 15 days, except for portion of total price representing services used. N.Y. Gen. Bus. Law §§ 620-631.

Ohio: Prepaid entertainment contracts. Buyer liable only for portion of contract used prior to death or disability. If either buyer or seller relocates more than 25 miles away and and contract cannot be transferred to similar facility, buyer only liable for portion used. Ohio Rev. Code Ann. §§ 1345.41 -.50 (Page).

4. Warranties

a. Implied warranties

Under the Uniform Commercial Code, the sale of goods gives rise to an implied warranty of merchantability, and, in particular, a warranty that the goods are fit for ordinary purposes. An implied warranty that the goods are fit for a particular purpose arises when the buyer relies on the seller's knowledge or expertise, and the seller is aware of this reliance. Sellers can modify or exclude both types of implied warranty through express disclaimers. The U.C.C. also allows sellers to restrict or exclude buyer's remedies for breach of warranty. U.C.C. §§ 2-314 to -316.

Eleven states */ have modified the UCC to prevent disclaimers of implied warranties and remedies in sales of consumer goods. A few of these modifications apply to consumer services, as well. Most states that prohibit disclaimers do allow sales of used goods to be made on an "as is" basis, however, if the seller clearly notifies the buyer that the buyer is assuming the risk of any defects.

b. Warranties on specific types of goods

(i) Mobile homes **/

Seventeen states have enacted legislation prescribing warranties on new mobile homes. Liability for fulfilling warranties falls upon the manufacturer alone, the manufacturer and dealer jointly and severally, or the manufacturer and dealer separately for different parts of the warranty. Warranties must guarantee that a mobile home is without substantial defects in material or workmanship or that the home complies with applicable code standards, or both. Electrical, heating and plumbing systems, and appliances installed by the manufacturer are usually covered by the warranty. Warranty terms of one year are established in every state but Arkansas, where the duration of the warranty is not specified in the statute. Ark. Stat. Ann. § 82-3022. Three states further require that defects be corrected within "reasonable time", while New York and Wisconsin require corrections within 60 days and 30 days respectively. Texas and Wyoming specify that ordinary repairs must be corrected within 30 days and 60 days respectively but major defects giving rise to safety or health hazards must be corrected sooner. N.Y. Gen. Bus. Law §§ 720-724; Wis. Stat. Ann. § 218.14; Tex. Rev. Civ. Stat. Ann. tit. 83, §522f (Vernon); Wyo. Stat. §§ 35-18-101 to -110.

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*/ California, Kansas, Maine, Maryland, Massachusetts, Minnesota, Oregon, Rhode Island, Vermont and West Virginia. Mississippi never adopted U.C.C. § 2-316, so disclaimers are not allowed on any sales of goods.

**/ Some warranty provisions apply to both mobile homes and modular homes.

The mobile home warranty law of Kentucky is worthy of particular note, because it effectively acts as a "lemons" law. Under this law, a presumption of unmerchantability arises if an owner has had to have a major defect repaired on three separate occassions during the first 12 months. A major defect is one that costs the owner at least 4 percent of the purchase price to remedy and gives rise to an imminent danger to health, safety or right of occupancy. Once the owner has notified the manufacturer that the mobile home is unmerchantable, the manufacturer must inspect the home within 10 days and determine that: (a) no defect exists; (b) any defect was caused by the owner or third persons; (c) a defect exists and will be promptly remedied, and the warranty extended four months; or (d) the home is unmerchantable. If the owners must be rehoused, it must be at the manufacturer's expense. If the defect cannot be repaired, the manufacturer may either refund the purchase price, less any diminution due to abuse by the owner or third persons, or provide a new home of the same model and year.

The owner may bring an action to recover the purchase price, less diminution in value due to abuse, if the owner notified the manufacturer within 10 days after the unmerchantability became evident, and the manufacturer refused to correct it. Ky. Rev. Stat. Ann. §§ 367.710-.775 (Baldwin).

(ii) New homes

Although many jurisdictions recognize an implied warranty of habitability under the common law, only four states have enacted legislation providing warranties on new homes. The New Jersey law, enacted in 1977, is the only law that creates an express warranty that cannot be disclaimed by the builder. The warranty must guarantee that a home has been constructed according to standards established by the housing commissioner. Each type of defect is warranted for a different period, as follows: (1) One year warranty that the dwelling is free from defects caused by faulty workmanship or materials due to noncompliance with building standards; (2) Two year warranty that the dwellings is free from defects caused by faulty installation of electrical, plumbing, heating and cooling system; (3) Ten year warranty against major structural defects. The builder's liability is limited to the purchase price of the home in its first good faith sale. N.J. Rev. Stat. Ann. §§ 46:3B-1 to-12 (West).

Three states, Connecticut, Maryland and Virginia, provide for a one-year implied warranty that new homes are free from structural defects, constructed in a workmanlike manner and fit for habitation. The Connecticut and Maryland provisions do not apply to defects that a reasonably diligent buyer could discover upon inspection. All three provisions allow partial or total disclaimers, if the contract clearly and conspicuously sets out modifications and exclusions. */ Conn. Gen. Stat. §§ 47-116 to -120; Md. Real Prop. Code Ann. §§ 10-201 to -205; Va. Code § 55-69.

(iii) Condominiums

Connecticut, New Hampshire and Virginia require new condominiums to be warranted against structural defects. Both the common areas and individual units are covered. The warranty period for common areas begins when the first unit is conveyed; the period begins for each unit when it is conveyed to the first bona fide purchaser. The warranty is for one year in Connecticut and New Hampshire and two years in Virginia. Only the declarant is held liable for defects under warranty in New Hampshire and Virginia; in Connecticut, however, liability is allocated among declarants, contractors, subcontractors and suppliers, with the warranty period beginning as each person completes work. Conn. Gen. Stat. § 47-74e; N.H. Rev. Stat. Ann. § 356-3:41; Va. Code § 55-79.79(b).

(iv) Motor vehicles

Sales of motor vehicles are covered by general implied warranty provisions, discussed above. The Oregon consumer warranty law specifically includes motor vehicles. It further provides that the implied warranty shall run for one year or 12,000 miles, whichever occurs first. If the vehicle is covered by an express warranty, the implied warranty runs for the length of the express warranty, but may not be longer than the statutory duration nor shorter than 60 days. Or. Rev. Stat. §§72.8010-.8200.

Maine requires dealers to issue a written warranty that every used car sold has been inspected and complies with statutory regulations. Although the warranty required is not very extensive, the law does provide further warranty protection. For example, it also requries dealers to make extensive disclosures, including a complete description of any other warranties. Furthermore, dealers must make any warranty repairs within five days, or within 35 days if parts are not available. If the repairs are not completed within the period specified, the dealer must provide the buyer with the use of a car at no cost, except for oil and gas. Me. Rev. Stat. Ann. tit. 10, §§ 1471-1477.

Manufacturers of motor vehicles or engines sold in California must warrant that their products are designed, built and equipped to conform to applicable emission standards, and that they are free from defects in materials or workmanship that would cause them

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*/ Under the Louisiana civil code, sales of real property, as well as personal property, carry an implied warranty of fitness for the intended purpose and that the thing sold is free from hidden defects; implied warranties may be excluded or modified by express agreement. La. Civ. Code Ann. arts. 2475-2476.

to fail to conform to emission standards during their "useful life." "Useful life" is defined as five years or 50,000 miles. A state agency may prescribe a longer life for heavy-duty vehicles. Cal. Health and Safety Code § 43204 (West).

One other attempt at imposing mandatory warranties on motor vehicle dealers or manufacturers is the South Carolina bumper warranty. Every passenger car sold in the state must carry a manufacturer's warranty that it will withstand impacts of speeds of 5 m.p.h. forward and 2.5 m.p.h. backwards without sustaining damage, and impacts at 5 m.p.h. in either direction with only minor damage to bumpers. No warranty is necessary if the manufacturer files a certification that the standards are met. S.C. Code §§ 56-5-4910 to 4940.

(v) Other

Under the Michigan fine arts warranty law, an express warranty of authenticity is created by any written statement by an art merchant that identifies the work with an author, school or period, even if no warranty is intended. Disclaimers are not valid if they are not clear, conspicuous and specific. The warranty is breached if the work proves to be a counterfeit, or if an unqualifed statement of authorship was made and was false, mistaken or erroneous at date of sale. The law does not apply to sales to other art merchants. A dealer is liable only for the purchase price if the warranty was made in good faith. Mich. Comp. Laws Ann. §§ 442.321 to .324.

b. Procedural requirements

Two types of requirements directly affect the performance of warranty obligations: statutory time limits by which warranty work must be completed and tolling laws. Both types of requirements are included in many of the specific warranty laws discussed above. The following laws, however, have general applicability to consumer goods:

California: Song-Beverly Consumer Warranty Act. Repairs must be completed by manufacturer or by authorized repair facility within 30 days; period extended if delay caused through no fault of manufacturer or repair facility. Tolling: Warranty period automatically extended by length of time goods in repair; applies only to goods with purchase price over $50. Cal. Civil Code §§ 1790-1795.7.

Maryland: Tolling law. Warranty automatically extended if warrantor fails to correct defect within warranty period; warranty only terminates when the product successfully performs its intended function for remaining warranty period plus period equal to time of repair. Md. Com. Law Code Ann. § 14-404(a).

Rhode Island: Repairs must be completed within 30 days. If repairs being made by authorized facility and parts not in stock, parts must be ordered within two days and repairs completed 10 days after parts arrive. Period extended if delays caused by conditions beyond control of person making repairs. R.I. Gen. Laws § 6A-2 329.

D. Standards

Two types of standards are incorporated in state laws creating PPRs. Warranty laws often define the standards a manufacturer must guarantee his products to meet. For example, a mobile home warranty may guarantee that a home is constructed in accordance with the applicable building or safety codes, or, more generally, that it is constructed in a workmanlike manner. A more interesting group of standards, however, comprises various contract requirements, such as maximum duration, maximum contract price and maximum down payment. Contract standards play a major part in the following laws:

California: *Dance studios*. Payments may not extend beyond two years, though lessons may continue over seven-year period. Maximum contract price of $2,500. Cal. Civil Code §§ 1812.50-.68. *Health Studios*. Same contract length. Maximum contract price of $500. *Id.* §§ 1812.80-.96.

Connecticut: *Health clubs*. Maximum contract length of 36 months. If club offers contracts for more than 24 months, it must also offer 24-month and 12-month contracts, and so on. Prices for contracts of each length must be printed on every contract. Club may offer renewal option, but automatic renewal prohibited. Conn. Gen. Stat. §§ 19-341a to -341j.

Florida: *Health studios*. Maximum contract length of 36 months, renewable at end of period. Fla. Stat. Ann. § 501.012 (West).

Louisiana: *Dance studios*. Contract or series of contracts cannot be for more than 100 hours of private services or $5,000, whichever is less. Payment not to extend over more than two years; services may extend for seven years. La. Rev. Stat. Ann. §§ 51:1554 -:1566 (West).

Minnesota: *Club contracts*. Maximum contract length of 18 months; may be converted into longer contract after six months. Applies to health, social referral and buying clubs. Minn. Stat. Ann. §§ 325.96 - 965 (West).

New York: *Health clubs*. Maximum contract price of $1,200, except for clubs providing racquet game facilities renewable. Installment payments must be substantially equal and payable at regular intervals, not to exceed one month. N.Y. Gen. Bus. Law §§ 620-631 (McKinney).

Ohio: Prepaid entertainment contracts. Maximum contract length of three years. Maximum charge that may be made before the facility becomes available to the buyer is $50 or 10 percent of the contract price, whichever is greater. Ohio Rev. Code Ann. §§ 1345.41-.50 (Page).

Unlike the above provisions, the California law governing contracts for discount buying services requires that contracts include a mandated performance standard: Every contract must provide that the buyer may obtain a full refund of the down payment on goods ordered if they are not delivered within six weeks. Cal. Civ. Code §§ 1812.100-.128.

APPENDIX D

EXAMPLES OF INFORMATION DISCLOSURE AND THIRD-PARTY CONTRACTUAL AGENTS

The examples reproduced here exemplify 1) the use of information to improve the market's operation regarding post-purchase remedies, and 2) the role of third-party agents who perform information, negotiation and enforcement functions on behalf of consumers.

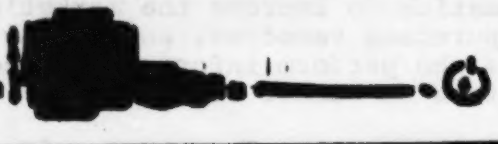
The sample Ford Motor Co. "Technical Service Bulletin" discloses product risks. This will be made available to Ford owners and prospective buyers: owners can use the information, particularly prevention information, to reduce risk; prospective buyers can use the information to assess risks, which will influence their demand for warranty protection from the seller and for service contracts.

The proposed window sticker disclosure form from the proposed rule on Sale of Used Motor Vehicles would give information of several sorts to prospective buyers. The inspection results will disclose risk and quality information about the car. The warranty disclosure describes how the risk is shared. These explicit disclosures should facilitate buyer-seller bargaining over terms and price. The form itself becomes part of the contract in order to reduce enforcement costs: when quality and warranty information is given only orally, it is costly to prove in any subsequent dispute. For this reason, the form cautions consumers to prefer written representations on the form over the seller's oral promises.

The American Automobile Association (AAA) Approved Auto Repair Service Program Contract represents a service performed by AAA for its members to reduce their risks in obtaining auto repairs, assure them of a minimum post-purchase protection, and reduce enforcement costs in the case of a dispute. AAA enters the contract only with shops that meet minimum qualifications, to reduce the risk of improper repairs. Paragraph 3 calls for written estimates to prevent "surprise" repair bills; Paragraph 5 calls for a minimum warranty on repairs. Paragraph 8 gives AAA the authority to decide any dispute over repairs between an AAA member and a participating shop; the shop agrees to be bound by the decision.

TECHNICAL SERVICE BULLETIN

No. (TSB Number)
Component Identification



All vehicles need repairs during their lifetime. Sometimes Ford issues Technical Service Bulletins (TSBs) and easy-to-read explanations describing unusual engine or transmission conditions which may lead to costly repairs. Often a repair now can prevent a more serious repair later. Information provided in TSBs is designed to assist you and your dealer in the correction of unusual conditions. Ford Motor Company and its dealers are pleased to provide you this TSB.

DESCRIPTIVE TITLE

Car Identification

Car lines and model years to which the TSB applies will be listed here.

Description

This section will contain an explanation, in layman's terms, of the service condition addressed in the TSB.

Symptoms of Condition

This section will describe operating conditions that would indicate the possible need to have the vehicle checked for the condition outlined in the TSB.

Consequences

This section will describe the repairs that may be necessary—if inspection and diagnosis are delayed—after the symptoms are first noticed.

Estimated Costs

This section will provide:

Parts Cost: The suggested retail price of the parts required to complete the necessary repair procedures.

Labor Cost: Labor costs will be indicated in terms of time required to complete the repair procedures, and the extension of that time at the National Average Warranty Labor Rate.

Prevention

If there are maintenance or repair steps that can be taken to minimize or avoid the condition addressed in the TSB, those steps will be outlined in this section.

Repair Procedures

Appropriate repair procedure will be provided in this section, including a list of any parts that may be required.

Adjustment Terms

This section will address the issue of payment responsibility.

FORD PARTS AND SERVICE DIVISION

BUYER$GUIDE

Dealer

NAME

ADDRESS

Condition

OK	NOT OK		WE DON'T KNOW
☐	☐	Frame & Body	☐
☐	☐	Engine	☐
☐	☐	Transmission & Drive Shaft	☐
☐	☐	Differential	☐
☐	☐	Cooling System	☐
☐	☐	Electrical System	☐
☐	☐	Fuel System	☐
☐	☐	Accessories	☐
☐	☐	Brake System	☐
☐	☐	Steering System	☐
☐	☐	Suspension System	☐
☐	☐	Tires	☐
☐	☐	Wheels	☐
☐	☐	Exhaust System	☐
NO	**YES**		
☐	☐	Flooded or Wrecked (once an insurance "total loss")	☐

Look at the back of this form for the details of our inspection.

Items Marked "OK"

If anything we've marked "OK" is not OK, state law says we have to fix it or give you back some money. And, if the problem's bad enough, you can make us take the car back. This is true whether you buy with a warranty or "as is." You must tell us within ________

after delivery if something marked "OK" is not OK.

Items Marked "Not OK" or "We Don't Know"

You pay all the costs to fix things marked "We Don't Know" or "Not OK" and explained below. Here is what's wrong with things marked "Not OK" and how much repairs should cost.

SEE FOR COMPLAINTS

VEHICLE: MAKE MODEL

MODEL YEAR VEHICLE ID NUMBER

Warranties

No Warranty ("As Is") ☐

This means you will pay all costs to fix things that break after you buy. But we have to pay to fix things marked "OK" if you tell us within ________ after delivery.

A seller's spoken promises may be no good when you buy "as is." Ask us to put all promises in writing. You can make a seller keep written promises even when you buy "as is."

Full/Limited Warranty ☐

SYSTEMS COVERED

DURATION

We will pay ___ % of the total repair bill. Ask us for a copy of the warranty. **This warranty adds to our responsibilities for items marked "OK."**

A seller's spoken promises may be no good. Ask us to put all promises in writing. State law "implied warranties" may give you more rights than this warranty.

Service Contract/ Repair Insurance ☐

is available from ____________
CONTRACTOR'S/INSUROR'S NAME

for $ ________ extra. Ask us for a copy.

Important: The information on this form is part of any contract to buy this vehicle. Removal of this label before consumer purchase (except for purposes of test-driving) is a violation of federal law (16 C.F.R. 455)

If a system is marked "OK," it doesn't have the problems listed below:

Frame & Body

Frame — apparent cracks, corrective welds, or rusted through
Dogtracks — bent or twisted frame
Inoperative doors

Engine

Known or visible oil leakage, excluding normal seepage
Cracked block or head
Belts missing or inoperable
Knocks or misses
Abnormal visible exhaust discharge

Transmission & Drive Shaft

Improper fluid level or visible leakage, excluding normal seepage
Cracked or damaged case, which is visible
Abnormal noise or vibration
Improper shifting or functioning in any gear
Manual clutch slips or chatters

Differential

Improper fluid level or visible leakage, excluding normal seepage
Cracked or damaged housing, which is visible
Abnormal noise or vibration

Cooling System

Improper fluid level or visible leakage
Leaky radiator
Improperly functioning water pump
Inadequate antifreeze strength for season of year

Electrical System

Improper fluid level or visible leakage of battery
Battery fails to start engine
Improperly functioning alternator, generator, or starter

Fuel System

Visible leakage

Broken Accessories

Gauges or warning devices
Radio
Air conditioner
Heater & defroster
Windows
Dash lights

Brake System

Failure warning light broken
Pedal not firm under pressure (DOT specs.)
Not enough pedal reserve (DOT specs.)
Does not stop vehicle in straight line (DOT specs.)
Hoses damaged
Drum or rotor too thin (mfgr. specs.)
Lining or pad thickness less than 1/32 inch
Power unit not operating or leaking
Structural or mechanical parts damaged

Steering System

Too much free play at steering wheel (DOT specs.)
Free play in linkage more than ¼ inch
Steering gear binds or jams
Front wheels aligned improperly (DOT specs.)
Power unit belts cracked or slipping
Power unit fluid level improper

Suspension System

Ball joint seals damaged
Structural parts bent or damaged
Stabilizer bar disconnected
Spring broken
Shock absorber mounting loose
Rubber bushings damaged or missing
Radius rod damaged or missing
Shock absorber leaking
Shock absorber functioning improperly

Tires

Tread depth less than 2/32 inch
Sizes mismatched
Visible damage

Wheels

Visible cracks, damage or repairs
Mounting bolts loose or missing

Exhaust System

Apparent leakage

Inspection procedures and "DOT specs." are printed in Vol. 16 C.F.R. (Code of Federal Regulations)Part 455.

APPROVED

AAA

AUTO REPAIR SERVICES

APPROVED AUTO REPAIR SERVICES
PROGRAM CONTRACT

This Agreement made and entered into by and between the ______________________ ______________________ having its principal place of business at ______________________ ______________________ hereinafter referred to as the AAA, and ______________________ ______________________ located at ______________________ hereinafter referred to as the Approved Facility.

In consideration of the mutual promises of the parties hereto, they hereby agree as follows:

1) The AAA will make a reasonable effort to inform its members of the Approved Auto Repair Services program. The term "Member" as used in this contract shall be understood to mean a member of the AAA, or a member of any Club affiliated with the American Automobile Association, who presents a current membership card showing AAA affiliation.

2) The Approved Facility agrees that during the term of this Contract it will, as an independent contractor, maintain and have available sufficient personnel and appropriate equipment to render, by appointment, an acceptable diagnosis and repair service during regular business hours to any member who requests such services and presents a valid membership card provided such diagnosis or repair is within the Approved Facility's areas of expertise and does not violate any franchise agreements. All buildings, including adequate waiting room and rest room facilities, grounds, equipment and personnel of the Approved Facility shall be clean, neat appearing and of a caliber satisfactory and acceptable to AAA.

3) Prior to initiating any diagnostic or repair work, the Approved Facility must offer to provide the AAA member a written estimate indicating work required, cost, and completion date. In the event detailed diagnosis or disassembly is required in order to make an accurate estimate, the charges for such work including re-assembly, where applicable, shall be disclosed to the member prior to engaging in such activity. The Approved Facility shall receive written authorization from the AAA member to make repairs on the basis of the written estimate. The AAA member may, by signature, waive his right to a written estimate and agree instead to a verbal estimate. Where it

is found that the work required will exceed the written or verbal estimate, the Approved Facility agrees to comply with state or local laws regarding repair estimates. But in any event, the Approved Facility must secure written or verbal authorization from the AAA member if the work required exceeds the estimate by ten (10) percent.

4) The Approved Facility has the right to refuse to accept a particular job, especially if it could be of a complex nature. However, once the repair has started, the Approved Facility must see to it that the repair is carried through speedily to a satisfactory conclusion. The Approved Facility will acquaint itself with recommended maintenance procedures for each vehicle it accepts for repairs, and will work in accordance with these procedures.

5) The Approved Facility must guarantee the effectiveness of repairs, parts, or components for 90 days or 4,000 miles under normal operating conditions. If due to the age or condition of the vehicle, there is risk that the repair may not be wholly satisfactory, the AAA member must be advised as soon as this is determined by the Approved Facility. This must be documented in writing.

6) The Approved Facility agrees to make available any replaced parts after the repairs are completed except parts required to be returned to the manufacturer or distributor under a warranty agreement. However, these parts must be available for inspection by the AAA member. The Approved Facility agrees to install new parts unless specific authorization to install used or rebuilt parts is obtained from the member. The invoice must state if used, rebuilt, or reconditioned parts were installed. The Approved Facility will not use additives to motor oil or gasoline without the member's consent. A copy of the invoice must be given to the AAA member upon payment of service.

7) The Approved Facility agrees to advise AAA of their retail labor rates and flat rate repair manuals at the time of contract signing and in writing ten (10) days prior to any change going into effect. AAA agrees to treat such information confidential until its effective date.

8) The Approved Facility agrees that in the event of a member's complaint to the AAA against the Approved Facility, the Approved Facility will cooperate fully in any investigation thereof. In the event of a dispute between the member and the Approved Facility as to whether repairs authorized by the member have been properly completed by the Approved Facility, a AAA representative shall have the right to inspect any work, materials, and charges and to inspect and obtain copies of diagnostic and repair records, invoices, or other records pertinent to the dispute and conduct such tests as

he deems necessary. Thereafter he shall report the results of the investigation in writing to the Approved Facility and the member. In the event he concludes that repairs have been improperly completed by the Approved Facility, the Approved Facility shall satisfactorily complete the repairs or refund the charge therefore to the member. The costs of the investigation and tests made by the AAA shall be borne by the AAA.

9) The AAA has and shall exercise no right to control as to the manner or methods employed by the Approved Facility in the rendering of services herein provided. It is agreed that the Approved Facility is an independent contractor and as such will maintain its diagnostic and repair facilities and provide diagnostic and repair services for members that meet the standards set by the AAA. The AAA may make periodic inspections of the Approved Facility's facilities, equipment and services performed and may make such tests thereof as it deems necessary to determine if said standards are being met.

10) The Approved Facility agrees to assume full responsibility for any negligence or willful misconduct upon the part of itself or its employees in performing any service hereunder and to hold the AAA, or its affiliates, harmless against all claims or demands of members or other persons for injury to or death of persons or for damages to property arising out of the services rendered by the Approved Facility under this Contract, and further that the Approved Facility will indemnify the AAA, or any of its affiliates, for all losses suffered by any of them as the result thereof.

11) The Approved Facility shall maintain, at its expense, garage liability insurance with policy provisions approved by AAA, including bodily injury liability coverage with limits of not less than $100,000 each person and $300,000 each occurrence, property damage liability with limits not less than $50,000 each occurrence, and garage keepers legal liability coverage of not less than $50,000, which may be subject to such deductibles as may be approved by the AAA. Said policies to be written by a company approved by the AAA. The Approved Facility shall furnish to the AAA certificates of insurance certifying to the coverages and an agreement by the insurance company not to cancel or change said insurance without mailing ten (10) days' written advance notice thereof to the AAA.

12) This Contract is not transferable or assignable in any way and any termination or change in the present ownership, management, or location of the Approved Facility shall automatically terminate this Contract at once with-

out notice. The AAA enters this Contract in reliance upon the present ownership and management of the Approved Facility. This agreement may be cancelled by either party upon the violation of any provision hereof or for fraud or unethical conduct practiced upon a member of the AAA by the Approved Facility or any employee thereof on a one (1) day's notice in writing and may be cancelled without cause by either AAA or Approved Facility by the giving of ten (10) days' written notice to that effect.

13) The Approved Facility agrees that no signs, insignia, stationery or any advertising whatsoever indicating a contract or affiliation with the AAA or its affiliates, shall be displayed, published or otherwise used, unless first approved by the AAA in writing. The Approved Facility further agrees that in the event of cancellation of this Contract to immediately remove and discontinue the use or display of signs and any other insignia, emblems, advertising or telephone listings indicating that the Approved Facility has any contract or affiliation with the Approved Auto Repair Services Program of ______________________________, AAA.

14) AAA will provide, free of charge, a Certificate of Approval to the Approved Facility for display in the establishment. The Certificate of Approval remains the property of AAA. In the event the Approved Auto Repair Services Program contract is cancelled, the Approved Facility will immediately discontinue displaying the Certificate of Approval and return the Certificate at its expense to AAA, Headquarters at Falls Church, Virginia.

15) The Approved Facility must meet all legal requirements of the county, city, or state in which it operates.

16) This Contract contains the entire agreement between the AAA and the Approved Facility and no modification or supplement to the terms hereof shall be binding unless in writing and signed by both parties.

______________________________ ____________
APPROVED FACILITY DATE

____
TITLE

______________________________ ____________
AAA DATE

____
TITLE

7/76 AE&RS

best copy available